98TH CONGRESS
2d Session

SENATE

REPORT
98-362

THE 1984
JOINT ECONOMIC REPORT

REPORT

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ON THE

FEBRUARY 1984 ECONOMIC REPORT OF THE PRESIDENT

TOGETHER WITH

ADDITIONAL VIEWS

MARCH 1 (legislative day, FEBRUARY 27), 1984.—Ordered to be printed

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REPORT ON THE FEBRUARY 1984 ECONOMIC REPORT OF THE PRESIDENT

FEBRUARY 27, 1984—Ordered to be printed

Mr. JEPSEN, from the Joint Economic Committee, submitted the following

REPORT

together with

ADDITIONAL VIEWS

[Pursuant to sec. 11(b)(3) of Public Law 304 (79th Cong.), as amended]

This report is submitted in accordance with the requirement of the Employment Act of 1946 that the Joint Economic Committee file a report each year with the Senate and the House of Representatives containing its findings and recommendations with respect to each of the main recommendations made by the President in the Economic Report. This report is to serve as a guide to the several committees of Congress dealing with legislation relating to economic issues.

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CHAIRMAN'S INTRODUCTION

ROGER W. JEPSEN, U.S.S.

The economy rebounded rapidly in 1983. However, complacency breeds indifferent policies, and the economy is still at risk. We are out of the woods, but we are not home free. Failure to adhere to the initiatives that are fostering economic growth will plunge the Nation back into stagnation

Most importantly, the monetary rollercoaster must be stopped. The Federal Reserve has failed badly in delivering the moderate monetary policy which the Administration requested three years ago. Short-run economic changes have been dominated by wild gyrations in the money supply. The Federal Reserve either has the "pedal to the metal" or they are on the brake. Unless there is more stability from the Federal Reserve, even the most enlightened fiscal policies might only lead to an economic wasteland.

The economy will enjoy a full recovery if we maintain tax relief, control the growth of Federal spending, and stabilize monetary policy. Recent tax legislation succeeded in reducing Federal tax revenues as a percentage of GNP in 1983 to the rate of taxation that existed in 1976 and 1977. Unfortunately, Federal spending increased significantly as a percentage of GNP during this period.

The growth of government partly reflects the temporary effects of the recession. However, part of the problem lies with Congress' inability to control entitlement programs and its own appropriations process. Unless the growth of Federal spending is controlled more successfully in the future, the economy is unlikely to reach its full potential.

Most would say that the economy was overtaxed in the mid-1970's. Yet, there are some who argue today that tax increases are appropriate, even though Federal revenues now represent the same portion of GNP as in the mid-1970's. This argument overlooks the fact that tax relief has boosted productivity. Tax increases would jeopardize future improvements in productivity, employment, and economic well-being.

Economic prospects naturally depend on policies other than Federal spending and taxation. We must avoid protectionism, which is economic suicide. Four out of every five new jobs in manufacturing are in the export sector, and one-third of our agricultural output is sold overseas.

Regulation still costs the country $100 billion a year. While the policies of the last three years have reduced the regulatory burden, more needs to be done.

Also, many traditional farm programs have become counterproductive. We need a new generation of farm policy that will better serve America and its farmers. We need to unleash agriculture's competitiveness and future potential.

The prospects for economic expansion are excellent, but the potential dangers that we face are very real. The Republican Members of the Joint Economic Committee support and welcome the general thrust of the President's program, but recognize that the final responsibility for tax restraint, spending control, and even monetary policy lies with Congress.

VICE CHAIRMAN'S INTRODUCTION

LEE H. HAMILTON, M.C.

Democratic Members of the Joint Economic Committee seek a recovery which is sustained, balanced, and fair. In this Report, we present our alternative to the policies of the Reagan Administration.

We propose a full economic and budget plan. Our program would reduce the budget deficit by $200 billion over the next three years, and by $500 billion from 1985 through 1989.

Our program is balanced. For every dollar of tax increases, we propose a dollar of spending reduction.

Our program is fair. We preserve and strengthen social security and those domestic programs which most effectively promote America's industrial competitiveness. We support this Nation's traditional compassion for the poor, the hungry, and the homeless.

We propose no general tax increase on the middle class or the poor. Our tax proposals would instead broaden the tax base, and restore to the tax system a measure of fairness.

Our program provides for a strong defense. We favor real increases in defense spending of 4 percent per year in each of the next five years. Given prudent management, and a commitment to diplomacy and to arms control, this would assure a strong and secure America in the years ahead.

Our program recognizes a need to review all aspects of the non-means-tested entitlement programs. Specifically, we propose to control the rapidly rising cost of health care.

Above all, our program would sustain real economic growth and move toward full employment. We would help keep America's commitment to provide jobs to all who seek them, along with reasonably stable prices.

Like the 1981 Reagan program itself, ours is a comprehensive program. We need something more than a deficit "down payment." Action is needed in 1984 to cure our problems. It will not be easier in 1985 than it is today.

The Democrats on the Joint Economic Committee propose a program which meets a national need. We call on the Administration and Congress to move promptly to put our economy on a path of sustainable, fair, and balanced growth.

REPUBLICAN VIEWS ON THE FEBRUARY 1984 ECONOMIC REPORT OF THE PRESIDENT

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I. THE ECONOMIC OUTLOOK

Consistent with the Republican views in The 1983 Joint Economic Report, the economy rebounded in 1983 at a much faster pace than most analysts, including those in the Administration, expected. However, the recovery of the last year cannot be blindly extrapolated into the future. Additional economic progress depends far less on where the economy has been than on the environment being created today by fiscal, monetary, and regulatory policy.

Those who were unduly pessimistic about the economy's recuperative powers tended to underemphasize both the impact of lower tax rates on productivity improvement and the effectiveness of faster money supply growth in stimulating demand in the short run. The erroneous forecasts of anemic recovery were based to varying degrees on extrapolation of sluggish production and spending trends, excessive concentration on nominal interest rate levels as the primary determinant of spending and investment plans, and excessive concern that record Federal borrowing might raise interest rates sufficiently to choke off private sector activity.

The recovery through 1984 and beyond will depend on the same factors that brought about the gains in 1983. Over the longer term, economic gains will depend largely on the ability of the economy to sustain improvement in productivity. Since 1983 saw the largest one year increase in productivity since 1976, the statistics are encouraging that a prolonged recovery that reaches full employment by 1987 is possible.

Monetary policy dominated short-run developments in 1983 and presents the biggest question mark regarding the recovery in 1984. Although the economy was poised for recovery at the end of 1982, with record excess capacity in manufacturing, falling break-even costs in business, and a ready and eager workforce, the economy received its biggest boost from a surge of monetary stimulus between the summers of 1982 and 1983. Since the summer of 1983, money growth rates have been moderated to prevent a renewed upward spiral of inflation. While the present concern with inflation is appropriate and commendable, overzealous pursuit of stable prices by the Federal Reserve could cause a serious temporary decline in spending, in spite of improved fundamentals that point to a lengthy recovery.

If continuing efforts to retain lower tax rates, restrain the growth of government spending to reduce the deficit, and moderate the volatility of monetary policy are successful, the prospects are excellent that the country will enjoy an extended economic resurgence of the type not seen since the 1950's and 1960's. A reasonable scenario under these conditions would include growth in real output averaging 4 percent or better annually until the economy reaches full employment, perhaps by the end of 1987. During this period inflation could average less than 5 percent, interest rates should decline further, and unemployment might drop to around 6 percent. Although Federal budget deficits are likely to remain much larger than historical averages, expansion in the tax base and additional control of the growth in government spending would lead to a diminishing burden of deficit financing on economic growth.

This hopeful view of the future, however, should not lead to complacency. Much needs to be done in economic policy, and even more needs to be avoided. Now that the economy has momentum and we have cut back the tangled web of government intervention, we must be careful to pursue those government programs that are in the public interest without unduly hampering our dynamic system based on individual freedom and choice.

PROSPECTS FOR A PROTRACTED RECOVERY

First and foremost, government should strive to provide a policy climate that will maximize long-run economic growth. Pursuit of short-run expansion alone will be of little solace if the recovery which began at the end of 1982 gives way to bigger government and declining living standards later in the decade.

The economic well-being of our country can improve only if the productivity advances that have characterized most of our history are sustained. From the end of 1952 to the end of 1972, output per hour in the nonfarm business sector advanced at an annual rate of 2.4 percent with few setbacks. Over the same period, real gross national product advanced 3.5 percent, or about 1 percentage point faster than productivity because of growth in the workforce.

Since 1972 productivity has grown at a much slower pace. Between the fourth quarters of 1972 and 1978, productivity grew at only a 1.0 percent annual rate, or only two-fifths the growth rate of the preceding 20 years. Furthermore, during the three-year period of stagnation between the fourth quarters of 1978 and 1981, productivity actually declined at a 0.3 percent annual rate.

A number of explanations have been advanced to explain the dismal growth of output per hour worked during the 1970's. Among those that have merit are the rapid influx of an inexperienced workforce that lowered the ratio of capital to labor, an explosive increase in costly government regulation, and disruption from an unstable and escalating inflation, each of which had some negative impact on productivity. In addition, escalating marginal income tax rates are a factor closely associated with the productivity performance of the last 15 years. The cuts in the marginal rates legislated in 1981 appear to explain improvement in productivity since early in 1982, even though the recession continued until the end of that year.

Tax rates on incremental income, or marginal tax rates, have powerful effects on economic incentives. As marginal tax rates first fell prey to bracket creep in the early 1970's, only to rise even faster in the late 1970's and early 1980's, productivity steadily declined. One half of all taxable income is earned by individuals above the 70th income percentile (about $23,700 of gross income and $17,600 of taxable income for a family of four in 1979). Between 1971 and 1981, when productivity growth fell from 2.4 percent to −0.3 percent annual growth, the marginal tax rate at the 70th income percentile advanced from 21.9 percent to 29.9 percent.

By 1983, the marginal tax rate for the 70th income percentile had fallen to 26.0 percent. In turn, productivity advanced 3.5 percent during 1983. This was about 1.25 percent slower than the average for the first four quarters of postwar recessions, excluding that of 1980. However, the 1983 improvement increased relative to the preceding trend by 1.5 percentage points more than the average following other recessions. The heartening improvement in productivity suggests that the tax rate reduction is a fundamental cause of the strength of the recovery. If the recovery is to be sustained, significant effort must be made to avoid reversing the progress made in controlling taxes.

All postwar recoveries have returned the economy to full employment with the exception of that of 1980, a recovery that was short-lived since it resulted largely from the end of credit controls and an expansion of monetary stimulus. The strength and duration of economic recoveries typically are related to the severity of the preceding recession. This relationship exists both because it naturally takes longer to regain full employment the further output declines from the ideal, and because more severe recessions generate more excess capacity that can be brought back on stream relatively quickly.

One positive aftermath of the recession of 1981–1982 is that the odds are in favor of a relatively long and strong recovery, particularly if productivity gains can be maintained. The capacity utilization rate in manufacturing fell to an average of 71.1 percent in 1982, the lowest rate since the Federal Reserve began collecting these statistics in 1948. In predictable fashion, capacity utilization rebounded from a recession low of 68.8 percent in November 1982 to 79.9 percent in January 1984.

Further gains in capacity utilization are likely to moderate from the remarkable improvement in 1983. The pent-up demands that propelled real GNP growth forward at a 6.1 percent rate during the first four quarters of recovery have been satisfied to some extent. Also, increases in capital spending will begin to add to total capacity at an increasing rate as production expands further, thus reducing gains in the rate of capacity utilization.

At full employment, manufacturing industry historically has operated at about 90 percent of capacity. To reach this level of capacity under current expectations for capital investment, the economic expansion must continue until 1987 or 1988. As long as industry operates below 90 percent of capacity, the productive opportunities available for idle resources will encourage continued expansion. Coupled with the improved incentives that are implicit in lower tax rates, an improved productivity trend, a lower inflation and interest rate environment, and the assumption that further progress will be achieved in stabilizing monetary policy and controlling the growth of government, the unexploited potential for growth suggests that economic expansion could continue into the late 1980's.

MONETARY POLICY

Although excess capacity, incentives to invest and, most importantly, the improvement in productivity will determine the longer run course of economic development, monetary policy is more likely to influence shorter run cyclical changes. Cyclical variations in monetary policy have tended to overstimulate the economy during recoveries and overrestrain the economy during downturns, accentuating the cyclical nature of economic growth. Also, long-run growth is likely to be restrained if monetary policy is sufficiently unstable to generate excessive uncertainty and inflation.

Any number of factors may contribute to cyclical disturbances. However, the bulk of the evidence indicates that most short-run changes in nominal spending result from changes in money growth rates during the preceding two or three quarters. Most recently, highly variable policies have made the economy acutely sensitive to changing monetary patterns, and spending seems to be responding with an even shorter lag.

Inflation also is largely a monetary phenomenon, with inflation mainly being determined by money growth changes of the preceding two years. Consequently, abrupt changes in money growth normally have pronounced effects on economic growth for periods of up to one and a half years. Monetary expansions boost real growth in the near term, but the gain is soon eroded by inflation. Monetary contractions induce recessions, but declines in real growth are soon recaptured by lower inflation.

The importance of stable money growth cannot be overemphasized. Stable money growth would greatly increase the odds that the recovery can be sustained and that economic uncertainty will continue to diminish. Unfortunately, the history of the last eight years does not create much confidence that a significant improvement in monetary stability will be forthcoming.

Growth target ranges for M_1 (currency plus checkable deposits) were first published in 1976. These targets were established as a guide to the conduct of monetary policy, recognizing that monetary stability was essential both to the maintenance of price stability and to minimizing policy-induced business cycles. After meeting the target ranges in the first year, M_1 growth has been successively above or below the stated target ranges for the last seven years.

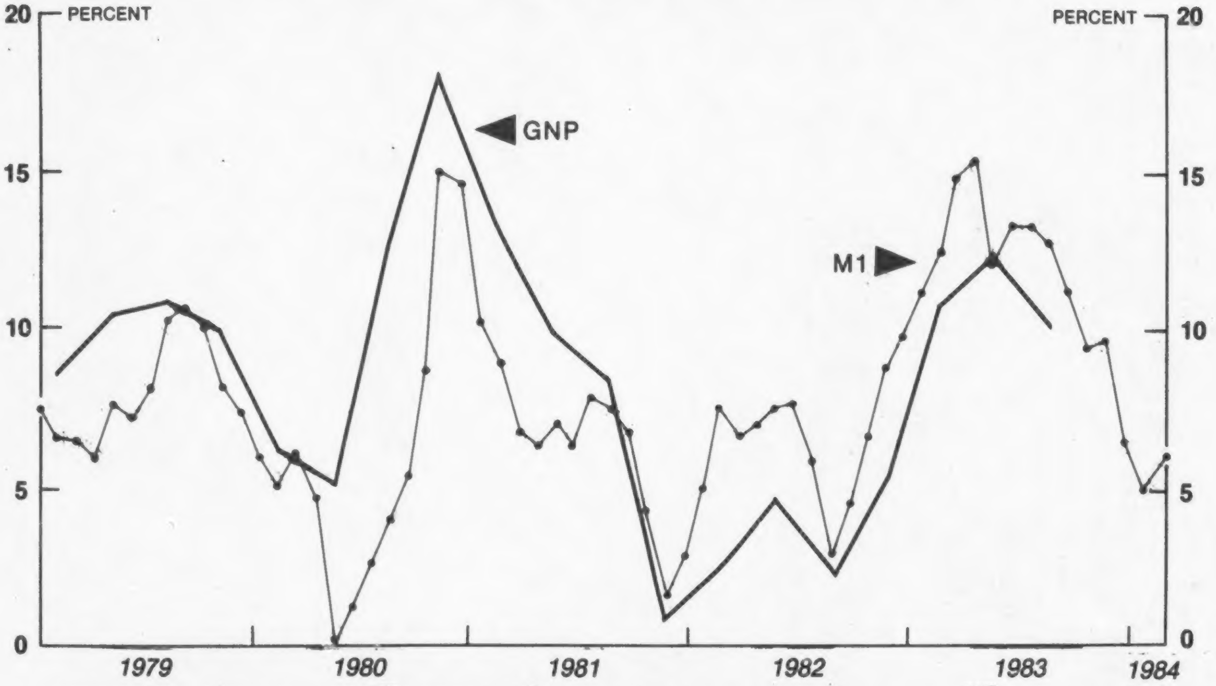
The Federal Reserve has tended to have an inflationary bias, missing the target ranges on the high side in six of the last seven years. The exception was 1981, in which a dramatic reduction in M_1 growth resulted in the target being missed on the low side, which led to a recessionary fall in spending by the end of that year. In 1983 M_1 ended the year within a revised target range measured from the second quarter. However, growth was above the upper target range that was initially established from the fourth quarter of 1982, then deemphasized, and later abandoned.

Between the second quarter of 1976 and fourth quarter of 1979, M_1 grew at a 6.7 percent annual rate and real GNP grew at a 4.1 percent annual rate. The standard deviation of M_1 was only 2.0 percent, and the standard deviation of real GNP was correspondingly low at 3.3 percent. From the fourth quarter of 1979 to the fourth quarter of 1983, the average growth rate of M_1 was little changed at 7.5 percent. However, the standard deviation of money growth almost tripled to 5.5 percent. The increased instability of monetary policy contributed to the fall in real GNP growth to 1.3 percent annually, less than a third of its former average. Also, the tripling of money growth variability almost doubled the standard deviation of real GNP growth to 5.1 percent.

The pattern of volatile money growth creating volatile spending patterns is illustrated in Chart I.1. In spite of protestations that institutional change, depository deregulation, and other special factors have disrupted the relationship between money growth and GNP growth, the relationship seldom has been more obvious than during the last five years. Especially noteworthy are the monetary contractions that precipitated the recessions of 1980 and 1981-1982 and the monetary expansions that facilitated the recoveries at the end of 1980 and during 1983.

CHANGES IN MONEY AND NOMINAL GNP

CHART I.1



FOOTNOTES: Changes in nominal Gross National Product (GNP) are two-quarter annual rates of change, plotted at the midpoint of the interval. Changes in money are six-month annual rates of change for M1, plotted with a 4-month lead at the midpoint of the interval. All data are seasonally adjusted and are current through January, 1984.

SOURCE: Federal Reserve Board; Department of Commerce, Bureau of Economic Analysis.

The most ominous feature of Chart I.1 is the slowdown in money growth that has occurred since the summer of 1983. While an adjustment of monetary policy was necessary to prevent a resurgence of inflation generated by double-digit money growth between mid-1982 and mid-1983, the decline in money growth to 6 percent for the six months ending in January 1984 suggests that the recovery may experience a near-term disruption. If money supply growth is kept at the bottom of the 4 of 8 percent range for 1984, the resultant gain in nominal GNP should be no more than 6.5 percent from fourth quarter to fourth quarter. At best, inflation, as measured by the GNP price deflator, should be held to 4.0 percent if money grows at 4 percent, resulting in real GNP growth of 2.5 percent or less during the calendar year. This would produce real GNP growth in the area of 3.5 percent on the basis of annual average data, which is about 1 percentage point below the forecast of the Federal Reserve and the Administration. Moreover, the downside risk that economic growth could be lower is substantial.

Such a pessimistic view of the economic recovery need not be realized if a policy of somewhat higher and stable growth in the money supply is pursued. The problem exists only because the economy once again is being subjected to a large change in money growth rates, this time one which will suppress spending relative to inflation. Tentative evidence of modest increases in bank reserves and money growth in December and January provide hope that an alteration of policy may be in the offing. On the other hand, the Federal Reserve still seems wedded to maintaining a 9.5 percent Federal funds interest rate target, a target that generated increasingly restrictive money growth in the second half of 1983 as inflation and inflationary expectations declined.

The foregoing recommendation of somewhat faster money growth is not to be construed as a call for generalized monetary expansion. The past few years have provided a demonstration not only of the cyclical impact of monetary policy, but the impact of monetary policy on inflation. Abstracting from the variability of money growth rates over periods of two and three quarters, annual money growth rates trended down between 1979 and 1982. As a result of slower money growth and improved productivity performance, inflation has declined through 1983. The difficult task before the Federal Reserve is to offset the contractionary effects of slower money growth during the second half of 1983, while avoiding any tendency toward an extended and inflationary money expansion.

The Federal Reserve's present policy appears to be dominated by fear of the inflationary effects of monetary expansion that occurred between July 1982 and May 1983, rather than by recognition of the cyclical effects that should emanate from the monetary restraint dating to the summer of 1983. This view is supported by the Federal Open Market Committee's reluctance to allow lower interest rates at their December and January meetings, and by the Federal Reserve's Humphrey-Hawkins forecast of uninterrupted economic growth in 1984. In fact, the Nation is unlikely to escape some inflationarv consequence of excessive money growth between the summers of 1982 and 1983. Nonetheless, the most efficacious policy would restore money growth rates to noninflationary levels more gradually to minimize cyclical economic effects. The path toward price stability is not necessarily one recessionary hardship, in spite of recent experience. Optimal monetary policy should provide slow, steady money growth that establishes prices stability without endangering the recovery.

THE 1984 MONETARY TARGETS

The money growth targets for 1984 were lowered slightly from the revised target ranges of 1983, as indicated in Table I.1. The practice of gradually lowering the target ranges is consistent with a policy of gradually reducing money growth to control inflation and minimize cyclical economic effects.

TABLE I.1—MONETARY GROWTH TARGETS

[In percent]

	Ranges for 1983	Ranges for 1984
M_1	5 to 9	4 to 8.
M_2	7 to 10	6 to 9.
M_3	6½ to 9½	6 to 9.

Although the target ranges have been reduced in an optimal manner, insufficient emphasis is being placed on the M_1 range. M_1 is the monetary aggregate that is most highly correlated with the changing spending patterns that determine business cycles and inflation, particularly in terms of cyclical turning points. Although the Federal Reserve is re-emphasizing M_1 growth in 1984, M_1 still does not hold its preferred status as the primary intermediate operating target.

In addition, the M_1 target range of 4 percentage points is unnecessarily wide. For most of the history of money growth targeting, the M_1 target range has been 2.5 percentage points wide. The additional range width was added in 1983 when depository deregulation brought the definition of money into question. However, continuation of wider target ranges encourages excessive exercise of discretion by the Federal Reserve, which increases the likelihood of volatile swings in money growth that have been the nemesis of the past five years.

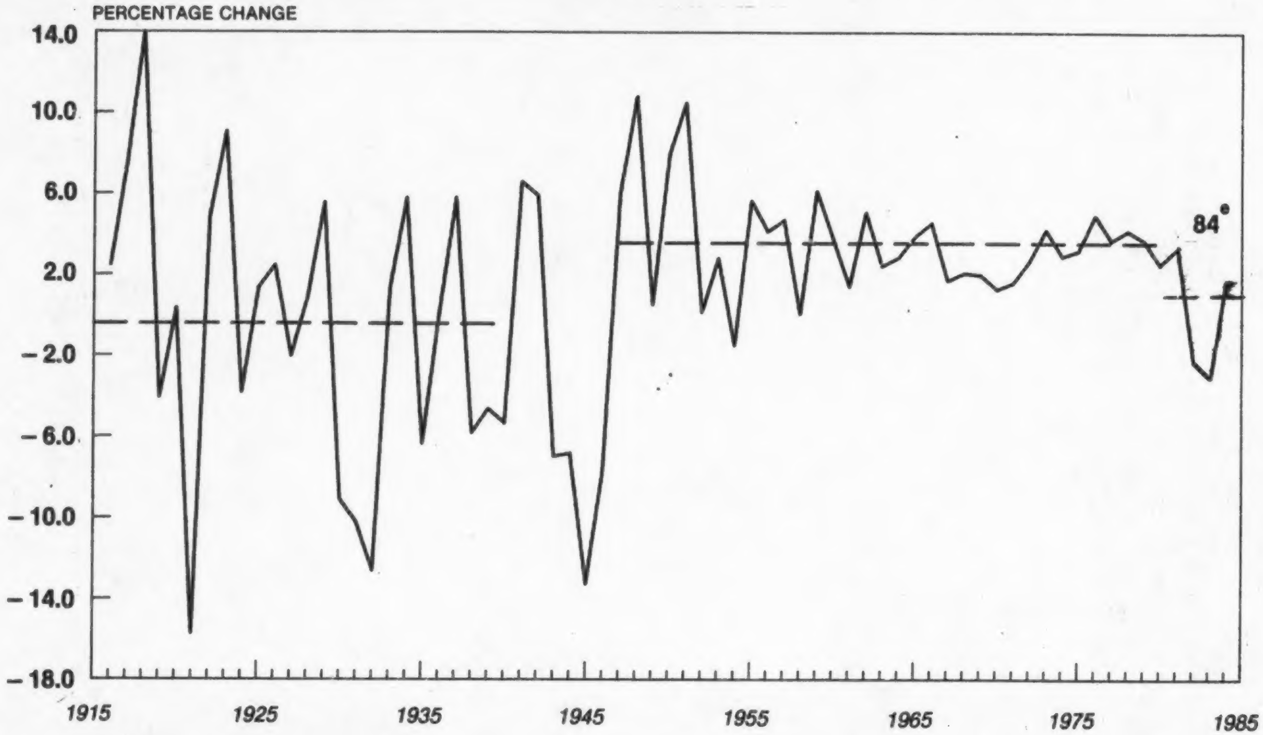
The Federal Reserve should endeavor to maintain a greater degree of monetary stability in 1984 than is implied by the target ranges. Moveover, the M_1 target objective should be narrowed by raising the lower portion of the range. Such a policy would minimize the cyclical shock caused by the transition from rapid money growth to slower money growth.

Money growth in the upper half of the range at 6 to 8 percent also would be appropriate if trend velocity (the ratio of nominal GNP to the money stock) remains lower than the postwar trend. Presently, the Federal Reserve is assuming that velocity will rebound to or above the historical trend in 1984, boosting spending and fueling the recovery even if money growth remains modest. The Federal Reserve has acknowledged that higher money growth would be appropriate if velocity growth remains on a lower track. It is likely that velocity growth, in fact, will remain on a lower track. The sooner the Federal Reserve anticipates and reacts to this outcome, the smaller will be the risk of an unanticipated economic slowdown.

To reach the conclusion that M_1 growth should be restricted to the upper part of the target range requires not only an understanding of the unusual decline in velocity relative to trend in 1982 and 1983, but an understanding of what caused the postwar trend in the first place. Chart I.2 illustrates the movement of velocity over the last 70 years. Velocity had little growth trend in the interwar years. In the postwar period, velocity grew steadily at about 3½ percent per year.

CHANGES IN ANNUAL GNP VELOCITY

CHART I.2



Dashed lines show average velocity growth; (1915-40) = −0.4%, (1947-80) = 3.6%, (1981-) = 1.0%
Velocity defined as GNP divided by M1 using annual data.

SOURCE: U.S. Department of Commerce and The Federal Reserve Board

The difference between velocity trend rates before and after World War II can be explained by the depression-era legislation that prohibited interest payments on demand deposits. Even though banks compensated depositors with additional services during the postwar period, this "barter" arrangement was less efficient than direct interest payments. As a result, the interest payment prohibitions led to continuing efforts to economize on, and substitute for, demand deposit balances. Given levels of M_1 money stock have supported increasing levels of GNP, imparting a continuing upward bias to velocity.

The recent decline in velocity growth results from changes in prohibitions on interest payments for demand deposits. In 1981 NOW accounts were introduced nationwide, and in 1983 Super NOW accounts became available. These accounts have grown rapidly to represent more than 30 percent of all checkable deposits counted in M_1. Consequently, since a significant interest bearing alternative is available among demand deposit accounts, the penalty for holding M_1 balances is reduced or eliminated, which reduces the motivation to minimize them. The upward trend in velocity should be expected to moderate permanently from the postwar trend.

The extent of the adjustment to trend velocity will remain in question until data become available over a complete business cycle. Nevertheless, it appears that velocity growth has fallen to a 1 percent annual trend from the previous 3½ percent annual trend. If this interpretation is correct, inflation should increase no further than the area of 5 percent in 1984. Moreover, the present M_1 target ranges of 4 to 8 percent are equivalent to ranges of 1½ to 5½ percent under the former velocity trend. Therefore, current policy is by no means expansive, and flirting with the lower boundaries of the range carries the risk of an unexpected setback in the recovery during 1984.

II. FEDERAL DEFICITS AND FISCAL POLICY

Huge future Federal deficits are of concern to the Joint Economic Committee and to the Congress as a whole. Unless legislative action is taken, the Federal deficit could average over $200 billion per year, or nearly 5 percent of the GNP, in Fiscal Years 1985 through 1989 based on the Administration's current services estimates. The cumulative deficit over this five-year period could exceed $1 trillion and result in a near doubling of the total Federal debt.

The fact that the Federal Government is running deficits is not, in itself, unusual. The Federal Budget has been in deficit in all but one of the past 20 years. In periods of recession, deficits temporarily expand as tax revenues fall and outlays for unemployment benefits and other cyclically sensitive programs rise. To a significant degree, the large Federal deficits of Fiscal Years 1982 and 1983 are due to these cyclical factors.

THE ECONOMIC RISKS ASSOCIATED WITH PROJECTED FEDERAL DEFICITS

Our principal concern is that—unless legislative action is taken—Federal deficits are projected to remain near record levels even after the current economic recovery is complete. This is shown in Table II.1, which presents total deficits and their estimated cyclical and structural components. The projections for 1984 to 1989 are current service estimates, i.e., without policy and program changes. In effect, they show how the budget would come out if we simply left the Federal Government on automatic pilot for the next five years.

TABLE II.1.—FEDERAL DEFICITS AND THEIR CYCLICAL AND STRUCTURAL COMPONENTS, FISCAL YEARS 1980–89

[In billions of dollars]

Fiscal year	Total	Cyclical	Structural
Actual:			
1980	60	4	55
1981	58	19	39
1982	111	62	48
1983	195	95	101
Estimates:			
1984	187	49	138
1985	208	44	163
1986	216	45	171
1987	220	34	187
1988	203	16	187
1989	193	−4	197

Source: Economic Report of the President, 1984, p. 36.

Historically, large Federal deficits have occurred during periods of slow economic activity when there was little private demand for credit. As a result, there is uncertainty about the extent to which Federal deficits—financed by Treasury borrowing—might push up interest rates and "crowd out" private investment in a recovering economy. Currently, there is little or no evidence that "crowding out" is a problem. Profits are large and cash flows are generous enough to finance most business expansion by internal funds and equity issues. We believe that domestic savings will prove sufficient to meet the borrowing needs of both the Federal Government and private industry this year, without additional upward pressure on interest rates.

There is considerable debate about the relationship between interest rates and deficits, and recent Joint Economic Committee hearings on the subject did not resolve the issue. Nonetheless, many economists believe that the impact of a continuing series of large Federal deficits on a strong economy would keep real interest rates high, thereby reducing investment and lowering our Nation's long-run rate of economic growth. If the deficits projected for 1986 through 1989 were to materialize, they could, under this theory, undercut the Administration's efforts to promote a higher rate of economic growth.

A second effect of the projected deficits—an effect about which there is no debate—is that they would raise Federal interest payments. As indicated in Table II.3 below, Federal outlays for net interest already represent 3.0 percent of GNP; this is up from 1.3 percent in 1965. Net interest outlays are now projected to increase as a percent of GNP even if interest rates decline. By 1989, Federal net interest payments could account for 4.1 percent of GNP and 16 percent of total Federal outlays. Ultimately, our ability to reduce government intrusion into the private sector could be restricted by the need to collect large revenues to service the Federal debt.

Some economists feel that the export sector of the U.S. economy is experiencing adverse consequences from large Federal deficits. High real interest rates in the United States are attracting funds from abroad. This inflow cannot be relied on to continue indefinitely, but while it lasts it augments domestic savings and alleviates any immediate danger that Federal borrowing might "crowd out" private investment. At the same time, however, the flow of funds changes exchange rates and makes American goods less competitive abroad (See Chapter IV).

We believe that the near-term effects of deficits are not of immediate crisis proportions. But a series of large future Federal deficits, such as those projected for Fiscal Years 1986 through 1989, could be harmful to the American economy. Steps need to be taken to remedy the existing structural imbalance between Federal outlays and revenues. We must not allow a prolonged series of Federal budget deficits to compromise our nation's prospects for higher standards of living at home and increased competitiveness abroad.

How Real Are the Projected Deficits?

The level of future Federal deficits depends both on Congressional action and on the state of the economy. During the first months of Fiscal Year 1984, the economy has shown surprising strength. Real GNP grew at an annual rate of 4.5 percent while the Nation's civilian unemployment rate fell to 8.0 percent in January. Should the economy continue to outperform expectations in Fiscal Years 1984 and 1985—and we believe that it may—Federal deficits in these years will fall below their projected levels, as they did in Fiscal Year 1983.

The deficits projected for Fiscal Years 1985 through 1989 are, however, due almost exclusively to a structural imbalance between Federal revenues and outlays, rather than to cyclical economic problems. The question is, how do we reduce them? Conceptually, there are three means by which this structural imbalance can be alleviated: (1) strong and sustained economic growth that brings about a substantial increase in revenue flows and lower entitlement spending, (2) legislated tax reforms that increase Federal revenues, and (3) legislated cuts in Federal spending.

THE ROLE OF ECONOMIC GROWTH IN ALLEVIATING THE DEFICIT PROBLEM

In the long run, economic growth is a very potent force. If the real growth rate of the U.S. economy had not declined during the late 1960's and 1970's, the Federal budget would now be in substantial surplus. Even over a shorter period, economic growth is a key factor in determining the balance between Federal revenues and outlays. For example, if the economy grows at a 5 percent annual rate from 1985 to 1989, rather than at the 4 percent annual rate that is assumed by the projections shown in Table II.1, the projected deficit for 1989 could be lowered by as much as $70 billion. Thus, policies to deal with deficits must avoid growth-inhibiting prescriptions.

We applaud the Administration's efforts to stimulate greater economic growth through incentives for saving and investment. However, we recognize we cannot rely on economic growth alone to resolve the deficit problem faced by the Nation. By historical standards, 5 percent represents a relatively high rate of economic growth for the United States over a long period. And a much greater rate of economic growth would be required to actually eliminate the deficit projected for Fiscal Year 1989. While economic growth can make a major contribution to deficit reduction, we cannot depend on such unexpected good fortune, particularly as the deficits may themselves absorb resources required to sustain rapid economic growth.

THE ROLE OF TAX REFORM

The appropriate solution to the deficit problem in the long run is not more taxes but less government. Nevertheless, some compromise between spending reductions and revenue increases may have to be made. CBO revenue and outlay projections indicate that even if discretionary domestic spending is frozen in real terms and the annual real growth rate of defense expenditutes is held to 5 percent, Federal entitlement benefit levels would have to be cut by 50 percent or more in order to balance the budget by 1989.

Tax reforms designed to raise some Federal revenue may be necessary. President Reagan has asked the Treasury Department to design a tax simplification plan that could make the tax system more fair and equitable and thus produce revenue from the underground economy. We endorse the President's request for such a study.

Congress must note, however, that the long-run solution to our deficit problem will be achieved only if the growth rate of Federal outlays is held below the growth rate of GNP. Thus, additional revenue must not be interpreted as a signal for relaxing spending restraint. Further, to ensure continued real economic growth, any tax reform initiatives must be carefully designed to avoid raising marginal tax rates and must protect incentives for savings, work effort, risk taking, and investment (see Chapter III). This would preclude surcharges and other across-the-board individual tax increases or business tax increases that would reduce internal cash flows.

THE ROLE OF SPENDING CUTS

The Repubican Members of this Committee are firmly committed to controlling Federal deficits through legislated cuts in Federal spending. There is no question where the real cause of our burgeoning deficits lies. Table II.2 shows Federal receipts, outlays, and deficits as a percent of GNP over the years 1965 to 1984. Receipts follow a fairly steady course, ending the period at 18.8 percent in 1984, where they began two decades earlier. Outlays, on the other hand, show a clear upward tilt, rising from a low of 19.7 percent during 1965–1969 to 24.7 percent in 1983 and 24.0 percent in 1984. Over the same period, deficits rise from a low of 1.0 percent during 1965–1969 to a high of 6.1 percent in 1983 and 5.2 percent in 1984. Obviously, it is uncontrolled increases in expenditures that is the cause of our deficit problem, not tax cuts. Receipts are at their historic average, but outlays are well above their historic average.

TABLE II.2.—RECEIPTS, OUTLAYS AND DEFICITS AS PERCENT OF GNP (1965 TO 1984)

Years	Receipts	Outlays [1]	Deficits
1965 to 1969	18.8	19.7	1.0
1970 to 1974	18.8	20.0	1.2
1975 to 1979	19.0	21.6	2.6
1980	20.1	22.4	2.3
1981	20.8	22.8	2.0
1982	20.2	23.8	3.6
1983	18.6	24.7	6.1
1984	18.8	24.0	5.2
Annual average: 1965–84	19.1	21.2	2.1

[1] Excludes Off-budget spending.

Source: Budget of the United States Government, Fiscal Year 1985, p. 9–60.

As further evidence that Federal spending is getting out of hand, between 1965 and 1983 Federal outlays increased 112 percent in real terms, while real GNP grew only 65 percent over the same period. This dramatic growth in the public sector took place at the cost of economic growth in the private sector, on which our overall economic welfare depends. Between 1950 and 1965, real GNP grew at an average annual rate of nearly 4 percent; between 1965 and 1983 the average annual growth rate of real GNP was only 2.8 percent.

Table II.3 shows the growth of Federal outlays by sector, as a percent of GNP, from 1965 to 1984. Increased Federal spending on social insurance and other entitlement programs—the major cause of our explosive budgetary growth—has not brought prosperity to many Americans. If we are to bring about a reduction in poverty and an increase in work opportunities for the disadvantaged, we must first achieve a vigorous, growing economy by curtailing the growth of Federal spending and Federal intrusion into the marketplace.

TABLE II.3.—GROWTH OF FEDERAL SPENDING BY SECTOR

[Percent of GNP]

	1965	1970	1975	1980	1984 [1]
Entitlement programs:					
Social security, medicare, and medicaid	2.6	4.0	5.7	6.4	7.2
Other entitlements	2.5	2.6	4.5	4.1	4.0
Total entitlements	5.1	6.6	10.2	10.5	11.2
"Discretionary" domestic outlays	4.7	4.5	5.1	5.5	4.4
National defense	7.2	8.1	5.8	5.3	6.6
Net interest	1.3	1.5	1.6	2.0	3.0
Offsetting receipts	−.5	−.6	−.8	−.8	−1.3
Total outlays [2]	18.0	20.2	21.9	22.4	24.0

[1] Estimated.

[2] Totals may not add due to rounding.

Source: Congressional Budget Office.

Congress, led by the Reagan Administration, successfully cut Federal outlays in 1981 for those domestic programs where expenditure levels are controlled directly by annual appropriations. In 1980, these so-called "discretionary" domestic programs represented 5.5 percent of GNP and 24 percent of Federal outlays. By Fiscal Year 1984, these discretionary expenditures had been reduced to 4.4 percent of GNP and 18 percent of Federal outlays. This is a major accomplishment.

Additional savings in discretionary domestic spending are possible. We must recognize, however, that entitlement programs (principally Social Security, Medicare, and Medicaid) now account for 46 percent of Federal outlays. National defense accounts for another 28 percent. Because of their size in relation to the total Federal budget, efforts to cut the rate of growth of Federal spending must seriously consider entitlement programs and national defense, the big ticket items comprising three-fourths of Federal outlays.

Entitlements.—Low income is not a major qualifying criteria for most Federal entitlement programs. The Congressional Research Service estimates that only 15 percent of Federal entitlement outlays in Fiscal Year 1984 will be for means-tested programs. We should, as a result, be able to reduce aggregate expenditures on entitlements without destroying the "safety net" on which the least fortunate Americans depend. One of the major factors behind the growth of Federal entitlements is that these benefits are, for the most part, fully indexed for inflation. A policy of partial indexation for the non-means tested programs could yield substantial savings without imposing undue hardship. The President's Private Sector Survey on Cost Control (The Grace Commission) has outlined several reforms that would cut the cost of many programs without violating the safety net.

Military Spending.—To resolve the deficit problem, it may also be necessary to slow the rate of growth of defense expenditures. But this must be done cautiously. As indicated in Table II.3 above, the proportion of GNP allocated to national defense eroded in the late 1970's. Military readiness declined, and we relied increasingly on aging or obsolete equipment to ensure our national defense. For a few years, this short-sighted policy helped the Federal Government meet the rapidly burgeoning costs of entitlement programs. We now face the task of up-grading our military readiness and modernizing our weapons systems.

As indicated by Table II.4, compensation for military personnel, military retirement, and funding for the operations and maintenance of equipment and facilities together account for over half of the total Defense Department budget authority for Fiscal Year 1984. Procurement of new combat and support equipment and other investment activities account for the remainder.

TABLE II.4.—TOTAL BUDGET AUTHORITY FOR THE DEPARTMENT OF DEFENSE IN FISCAL YEAR 1984

Appropriation account	Percent of total budget authority
Military personnel	19
Retirement pay	6
Operations and maintenance [1]	27
Procurement	33
Research and development	10
Military construction and other	5

[1] Includes civilian pay.

Source: Congressional Budget Office.

Outlays on military personnel could be reduced if Congress relied less on costly across-the-board pay raises and allowed the Services greater latitude in the use of reenlistment and other incentive pay programs targeted to meet their specific manpower needs. It is important, however, that cuts in the proposed defense budget be made in a balanced and careful manner. While immediate savings in outlays can be obtained by cutting appropriations for personnel and for operations and maintenance, these cuts could also have an immediate and adverse impact on our military capability.

GAINING CONTROL OF FEDERAL SPENDING

We know what needs to be done. Federal spending growth must be reined in. The concern of the Joint Economic Committee is that existing Congressional budget procedures are incapable of bringing that about. The Federal budget process is not working well. We seem to have a perpetual spending machine on our hands, and the budget process, as it now exists, cannot control it.

There are dozens of proposals before Congress to make substantive changes in the budget process itself. Examples of proposed changes include biennial budgeting, omnibus appropriations bills, combining appropriation and authorization committees into one set of program committees, making first Budget Resolutions binding, and providing multiyear spending levels in the reconciliation process. The number and nature of the proposals demonstrate how widespread the feeling is that the current system is not working well. We offer no opinion on these specific proposals, but we agree with the principle that budget procedures should be strengthened.

We believe, however, that something more than reform of the congressional budget process itself is needed in order to tighten fiscal control. We need new tools and institutional arrangements to limit Congress' propensity to tax and spend. We recommend three proposals that would go a long way toward solving the budget deficit problem. We should: (1) enact a constitutional amendment requiring balanced budgets, (2) give the President line item veto or strengthened rescission powers, and (3) establish a bipartisan panel to make specific recommendations for reducing deficits.

Balanced Budget/Tax Limitation Amendment.—A Constitutional Amendment requiring balanced Federal budgets may sound a little farfetched in our current world of $200 billion deficits. But a balanced budget amendment would get our attention and would force us to focus on the problem. It is the first essential tool in a package of budget reforms.

The chief proposals—S.J. Res. 5 in the Senate and H.J. Res. 243 in the House—would limit both deficits and tax increases. They would limit the growth in taxes by formula. Tax increases in any fiscal year could be no greater than the prior year's growth in national income.

The amendment discourages deficits by a combination of two provisions. First, Congress must plan a balanced budget. Planned outlays must be no greater than planned revenue. This is the basic budget balancing provision. Second, actual outlays may not exceed planned outlays. The basic requirements of a balanced budget and of tax increases limited to the growth in national income can be overcome by other provisions of the amendment, but not this second provision.

The amendment is sufficiently flexible to allow Congress to override some of its provisions if, for example, a threat of war necessitates deficit spending. In the event of any recognized national emergency, Congress can accept a deficit by a three-fifths vote of the full membership of both Houses. Thus, an unbalanced budget can be adopted, but it must be adopted by a vote on that subject alone. Also, by regular statute, Congress and the President may approve an increase in taxes greater than the growth rate of national income.

Line-Item Veto or Strengthened Rescission Authority.—Under existing law, there is no way to make surgical cuts in spending without rejection of an entire appropriation bill. Thus, the Presidential veto is seldom used on appropriation bills because it would require the President to reject funding for desired programs in an effort to eliminate or reduce spending for a few undesirable programs.

This reluctance to veto spending bills also allows some in Congress to load appropriation bills with pet projects that would never pass on their own merits. If the President had the authority to veto or rescind a certain percentage of these spending proposals on an individual basis, "logrolling" would diminish, spending proposals would face closer scrutiny, and the budget deficit would decline. Even if rarely used, the very existence of this line-item veto or strengthened rescission authority would impose a fiscal discipline on Congress, forcing it to resolve budget issues before a bill is passed. Thus, the impact of the line-item veto will be broader than the dollar amounts involved in individual vetoed items.

Over four-fifths of the State governors have line-item veto authority and they have used it effectively. This is a major reason why most State governments have been more successful than the Federal Government in achieving fiscal discipline.

Deficit Reduction Commission.—A third means of achieving reduction in Federal deficits is to establish a panel or commission to formulate a package of recommendations. In his 1984 State of the Union Address, the President called for a bipartisan Congressional panel to formulate a three-year $100 billion "down payment" on the deficit. We endorse this but we would carry the matter further. We recommend that Congress establish a full-fledged National Commission, along the lines of the AuCoin-Wylie proposal, H.J. Res. 382. Such a Commission should include private members appointed by the President, as well as Congressional appointees.

One purpose of the Commission would be to come up with the $100 billion deficit "down payment" that the President has asked for. In addition, the Commission would study the broad issue of structural deficits. It would review the effects of fiscal and monetary policy on deficits, as well as the impact of deficits on employment, capital formation, and the vigor of the economy. The Commission would assess how much government we really want and can afford. It would examine built-in devices to counter Congressional spending biases, it would propose reforms in the budget process, and it would analyze options for bringing deficits down. Moreover, the Commission could undertake a national campaign to inform citizens about tax and spending problems and the rationale behind alternative solutions.

For Congress to let this legislative year pass without making a start toward controlling deficits could cause some problems for the economy. Yet a polarized Congress becomes mesmerized in an election year. Members on both sides of the aisle have individual checklists of what ought to be spent and what ought to be reduced. The problem is, there is no legislative majority behind any one of those lists. The challenge we face is to build a bipartisan consensus on a legislative package that would enable Congress and the President to give ground on all of the sacred cows—entitlements, tax breaks, and weapons systems. Everything, except interest payments, is fair game.

A Commission can serve as a political heat shield during this challenging election year and can develop budget recommendations in a detached, objective way.

The Constitution and the budget process would not be violated. Congress would still retain final authority. It can accept or reject the Commission's recommendations. We believe the idea of such a Commission has considerable merit.

CONCLUSION

Our deficit problems have developed over a period of decades and they cannot be resolved overnight. While it is important that Congress make a start this year on the projected deficits for 1985-1989, there should be no attempt at drastic quick fixes. This could hurt the economy and destroy any hope for enduring economic growth. A gradual, steady course is the best policy. The markets are not calling for a balanced budget this year or next, but we should be moving in that direction, instead of away from it, as we have been the past few decades.

The right way to cut the Federal deficit is to combine continued economic growth with vigorous efforts to reduce Federal spending. As an overall benchmark, we believe that spending restraints should be sought to hold the growth rate of Federal outlays below the growth rate of GNP. In the long run, this will eliminate the structural imbalance between Federal revenues and outlays, and will allow reduction in the size of the Federal Government relative to the private sector.

To get the job done, the Administration and the Congress must join forces in developing the deficit reduction package.

III. TAX REFORM

Popular frustration with Federal income taxation is a recurring feature of modern life. From everyday experience one is constantly reminded how deep this frustration runs in taxpayers of all income groups. According to a 1983 survey by the Advisory Commission on Intergovernmental Relations (ACIR), *Changing Public Attitudes on Government and Taxation,* the Federal income tax is by far the least popular tax in the United States, outscoring even much disliked local property taxes. Thirty-five percent of the respondents rate the Federal income tax as the worst and most unfair of all, over three times the number identifying State income taxation as the worst.

Doubtless much of the unpopularity of the current tax code arises from the fact that its burdens are not imposed equitably. People with comparable incomes are not necessarily taxed alike. This inconsistency with the principle of horizontal equity results primarily from the various exclusions, deductions, exemptions, and tax credits, in the code. On the other hand, marginal and average tax rates had been so high for so long that many tax preference items were implemented to limit the counterproductive economic consequences of the oppressive tax structure. This is particularly true of special tax provisions designed to decrease the tax burden on savings and investment. To some extent, the existing "income" tax system already incorporates elements of consumption taxation.

The Internal Revenue Code and associated regulations create a Byzantine maze for taxpayers trying to determine tax liability and make tax-related decisions. Many of the provisions of the code and regulations are unclear to, and disputed by, knowledgeable tax experts. The average taxpayer is often unable to interpret the code and regulations without assistance from tax practitioners or the IRS. Unfortunately, if the IRS misinforms a taxpayer on interpretation of a tax provision, he is responsible for any resulting violations, according to the IRS. After all, ignorance of the law—and thousands of tax code regulations—is no excuse. The overwhelming complexity of the current tax system supports the view that tax simplification is both possible and desirable.

Efficiency is another important criterion of tax policy. To the greatest extent possible, the incidence of taxation should be "neutral" with respect to economic decisionmaking. Ideally, a neutral tax system would not change incentives, resource allocation, or otherwise deflect market forces from what they would be in the absence of taxation. As a practical matter, complete neutrality is probably an unattainable ideal. But by making the tax system as neutral as possible, economic efficiency can be improved. Obviously, the current tax system departs from the neutrality principle in many ways.

Another commonly applied principle of taxation is "vertical equity." This usually is interpreted to mean that people in different income classes should be taxed according to their "ability to pay." The problem is that there is no clear or universally accepted meaning of this concept. The inability to measure and compare the marginal utility of income of different persons renders the "ability to pay" notion imprecise. Though some degree of progressivity can be advanced on practical or normative grounds, there is no clear, objective formula to apply in designing the rate structure. Any argument in favor of one degree of progressivity can be used to support virtually any level of progressivity.

In sum, there is plenty of substance to the popular feeling that the tax system is arbitrary and unfair, if not downright oppressive. Consequently, a growing number of taxpayers believe they are justified in evading the system illegally. Thus, not only has the current tax code undermined economic growth and efficiency, but public morality as well. Though estimates of lost revenues from the various forms of tax evasion vary, most are in excess of $50 billion annually. Clearly, voluntary tax compliance is threatened by popular disaffection with the current income tax system.

ECONOMIC PROBLEMS WITH THE CURRENT SYSTEM

The crucial importance of adequate rates of savings and capital formation are universally recognized. Long-run economic health and U.S. international competitiveness both depend on sufficient saving and investment. Private capital formation is important for rising rates of labor productivity, real earnings, and employment. Given the quantity of labor services, an increase in the amount of capital will raise the marginal productivity of labor; thereby real wage rates and employment will tend to increase. In sum, a rising American standard of living is dependent, to a large extent, on adequate rates of saving and capital formation.

Technological progress is another important component of productivity and economic growth. As a practical matter, however, it is hard to separate the contribution to economic growth made by capital formation and that made by technological progress. They are interrelated to some extent, not only because research and development requires capital outlay, but because technology can be applied only through investment.

The current progressive marginal tax rate schedule is a formidable barrier to economic activity. Disincentives to work, save, and invest remain powerful, even after passage of the 1981 Economic Recovery Tax Act (ERTA), Pub. L. 97-34. A reform which dispensed with the number of brackets and the progressive rates of the current tax code would be beneficial in and of itself.

High marginal tax rates promote excessive caution in business decisionmaking by reducing the rewards for risk-taking. The tax system raises the threshold rate of return, makes many projects uneconomical, and discourages dynamic entrepreneurship. As the pace of innovation is slowed, U.S. international competitiveness is further eroded.

The income tax system undermines economic progress because it is biased against saving, capital formation, and innovation. The choice between saving and consumption is distorted by punitive treatment of saving. In large measure, taxes not only fall on the amount of income newly saved, but also on the yield of this saving. At the margin, the future income stream represented by saving is taxed twice, while consumption is taxed only once. The relative price of saving and consumption is altered by the income tax in such a way as to encourage consumption and discourage saving.

This current lack of neutrality regarding saving causes distortion. Current consumption becomes more attractive relative to future consumption and saving and capital formation suffers as a result. Although in recent years saving has been accorded more tax neutral treatment by expanded availability of Individual Retirement Accounts (IRA's), the dividend exclusion, and other provisions, a strong bias remains against saving. A wholesale revision of current tax law is necessary to remedy this serious problem.

AGENDA FOR TAX REFORM

Future tax reform must be based on alternatives to the familiar "soak the rich" reflex. It is now widely recognized that even confiscation of the income of the richest 1 percent could fund the Federal Government only for a few days. Clearly, future tax reforms and/or tax increases must be broadly based and comprehensive. The following are some options currently under discussion.

Consumption Taxation

The concept of consumption based taxation has gained increasing support in the last decade. The U.S. Department of the Treasury's 1977 *Blueprints for Basic Tax Reform* further stimulated interest in consumption taxation. By taxing people on what they withdraw from total wealth, rather than what they contribute, the tax base would be shifted from adjusted income to expenditure. Measurement of each item of expenditure would be impractical for purposes of tax administration.

Net saving and investment could be subtracted from total annual income to yield, net of allowable deductions, the tax base to which the tax schedule would be applied. Or, the return from saving and investment could be deducted from current income. This form of taxation would require special treatment of borrowing; loans would be included in the tax base at some point.

The most straightforward approach to defining the consumption tax base was provided in the *Blueprints for Basic Tax Reform*. The cash flow method would add the inflow of cash to the taxpayer from all sources and deduct cash outflows to saving and investment. The remainder, net of allowable deductions, would constitute the consumption tax base. Special "qualified accounts" would be established by each taxpayer through which tax deductible saving and investment would be channeled. Withdrawals from these accounts would be included in the tax base. The accounts would be set up at banks, savings and loan associations, brokerage firms, and other financial institutions.

A popular misconception maintains that consumption taxation is inherently regressive. However, the choice of a consumption base says nothing about its incidence upon different income groups. The important factor in this regard is the rate structure, not the tax base. The rate structure may be adjusted to make consumption taxation as progressive or regressive as any other tax system.

The elimination of taxation on net saving and investment would provide great economic benefits. The rate of saving in the United States is considerably below most of its international competitors, and clearly needs to be increased. Under the current system, saving is subject to double taxation. Other investment returns are subject to capital gains taxes on inflation-induced and illusory capital gains. This treatment of new saving and investment is not conducive to economic growth and is inequitable because, at any income level, those who save proportionately more will tend to be subjected to higher tax rates. Adoption of a consumption tax system would stimulate more saving and investment, technological progress, productivity, and U.S. international competitiveness, thereby raising American living standards.

Flat Rate Taxation

Another tax reform which has captured public support is the flat rate tax. Strictly speaking, the issue of a flat rate versus progressive tax rates concerns only the rate structure of the tax system, and not its base. It has been estimated that a flat rate of 19 percent applied to the current individual tax base (retaining all deductions, exclusions, and credits) would raise the same amount of revenue as the individual tax schedule in place in 1984. However, to raise the same amount of revenue at a significantly lower rate requires a broadening of the tax base, a tradeoff contained in many flat rate proposals. The amount of deductions, exclusions, and credits would have to be sharply reduced to establish a more comprehensive income base. However, the lower marginal tax rates applied to the broadened base generally would be less than most rates in the current tax schedule, reducing disincentives to work, save, and invest.

Much discussion of flat rate taxation includes proposals with more than one tax rate. However, a true flat rate tax can only have a single tax rate applied to all taxpayers, regardless of taxable income.

In order to raise the same amount of revenue on a static basis as the current system, some flexibility exists in setting the tax rate and the breadth of the tax base. As mentioned, the current tax base with a 19 percent flat rate could raise the same amount of revenue as the current schedule. The same or lower flat rate could be applied to another tax base to generate a different tax incidence. A generous standard deduction of several thousand dollars could decrease the tax burden of lower income persons relative to what it would otherwise be under flat rate taxation. The mix of possible tax rates and tax bases is almost infinite, and could be used for a wide variety of economic and social policy objectives.

PROPOSAL OF ROBERT HALL AND ALVIN RABUSHKA

The best known flat rate tax scheme is the Hall-Rabushka (Stanford University) proposal. Under this plan, embodied in S. 557, a 19 percent flat tax rate would be applied to both individuals and businesses. According to its proponents, this plan is based on four principles:

All income should be taxed only once, as close as possible to its source.

All types of income should be taxed at the same rate.

The poorest households should pay no income tax.

Tax returns for both households and businesses should be simple enough to fit on one page.

The basis of individual taxation would be total compensation from employers in the form of wages and salaries, value of fringe benefits, and pension contributions. Married couples filing jointly would be permitted to deduct a $6,700 "allowance," single persons a $4,100 allowance, and single heads of household $6,000. Further, there would be an allowance of $810 for each dependent. Income in the form of interest, dividends, and capital gains would not be included in the tax base. No other deductions would be permitted.

The allowances provided would ensure that very low-income persons would pay no taxes. A family of four with compensation of $8,320 would pay no tax, while families at progressively higher levels of income would pay tax on a rising proportion of income. The average effective tax rate would increase with the amount of compensation, making the flat rate in one sense progressive, albeit less severely so than the current system.

One of the most outstanding aspects of this reform is its simplicity. Individuals could file their tax returns on a form no larger than a post card. The need for tax advice would be minimal, because the source of confusion would be removed. Furthermore, horizontal equity would certainly be greater than it is now.

Tax treatment of businesses would be a bit more complicated. The income of all businesses, incorporated or not, would be taxed only once at a 19 percent flat rate. Capital investment could be expensed immediately. The cost of goods and services, and employee compensation would be deductible. Interest, depreciation, or payments to owners would not be deductible to the corporation.

This flat tax scheme has a number of attractive features. By cutting most marginal tax rates and by eliminating the double taxation of saving and the returns to saving, the incentive to save and invest would be greatly enhanced. With removal of the double taxation of saving and yield, intertemporal distortion would be reduced and economic efficiency would be improved. Furthermore, intersectoral resource distortion from special tax treatment would be removed, thus improving the allocation of capital. In the long run, the faster economic growth resulting from this reform would benefit all income groups.

However, this plan does present a number of political problems. Elimination of deductions for charitable contributions, medical costs, moving costs, mortgage interest, and other items does not appear to enjoy wide support. Of course, some deductions might be retained to achieve desired social policy ends. The key question is whether taxpayers would consider the lower tax rate a worthwhile trade for whatever deductions were eliminated. On a static basis, the more deductions that were retained, the higher the flat rate must be to collect the same amount of revenue as the current system.

Moreover, the sharp reduction in the top marginal rate for individuals has been attacked because it would allegedly reduce the share of the tax burden borne by the rich. However, earlier experiences with cuts in maximum marginal tax rates indicate that the share of the tax revenue paid by the very wealthy actually increased as a result.

PROPOSAL OF SENATOR BRADLEY AND REPRESENTATIVE GEPHARDT

The Bradley/Gephardt bill, S. 1241 and H.R. 3271, is often described as a type of flat rate tax, although this designation is something of a misnomer. Under this proposal, a flat 14 percent "normal" tax would be applied to taxable income, but a two-tiered progressive surtax schedule of 12 percent and 16 percent would be applied to incomes over $25,000 for singles and $40,000 for married couples. In effect, an individual's adjusted gross income would fall into one of three tax brackets, each levying progressively higher marginal tax rates ranging from 14 percent to 30 percent (combined normal and surtax rates).

The personal exemption would be $1,600 for single returns, $3,200 for joint returns, and $1,800 for single heads of households. The deductions for home mortgage interest, charitable contributions, State and local income and real property taxes would remain. Some transfer payments, such as social security and veterans benefits, would be excluded from taxation, but others, such as unemployment compensation, would not be deductible.

The primary benefit of this proposal is the sharp reduction in individual marginal tax rates. The top marginal rate would be cut from 50 percent to 30 percent. Marginal tax rates would decline for most taxpayers. While on the surface these rate reductions should increase incentives to work, save, and invest, there are some important offsetting negative aspects of Bradley/Gephardt.

First, inflation-indexing of the tax code is repealed. This hurts lower and middle-income taxpayers more than the wealthy. Since the legislation retains three progressive tax rates, there will still be considerable "bracket creep" from inflation.

Second, the capital gains tax rate is increased from 20 percent to 30 percent, a 50 percent jump that would be devastating to equity markets and thus to capital investment. Also, removal of the general exclusion for interest and dividends and the exclusion for interest on cash value life insurance would increase the cost of saving.

Third, Bradley/Gephardt is too complex. There is one personal exemption for adults, and a different (smaller) one for families with children. While claiming to retain deductions for mortgage interest, property taxes, and charitable contributions, Bradley/Gephardt allows only partial deductions. Sometimes deductions depend on gross income, and at other times on taxable income, effectively forcing people to figure out their taxes twice.

Fourth, while increased exemptions and standard deductions will drop many people from the tax system, lower income workers would be hit by higher payroll taxes on employer-provided health and life insurance and child care. Working couples would lose by repeal of the "marriage penalty deduction." Two-earner couples with children appear to lose the most.

With regard to corporations, a flat 30 percent income tax rate would be established. But the investment tax credit and other tax credits would be abolished, and the current rapid depreciation system would be replaced with longer write-off periods for equipment and structures. Capital-intensive businesses, so important to the industrial base of the United States, would be seriously harmed. Moreover, small companies would lose from the elimination of lower rates on the first $50,000 of taxable income. High-tech companies would lose from repeal of the research and development credit.

On balance, the Bradley/Gephardt bill would result in fewer incentives for saving, capital formation, and economic growth. The notion of increasing taxation of significant sources of saving and investment is moving tax policy in the wrong direction. The negative effects of extending the taxation of saving and investment may overwhelm the positive impact of lower marginal tax rates.

Tax Expenditures

A variety of "tax reforms" focus on broadening the tax base by reducing so-called "tax expenditures." These are usually defined as tax exclusions, exemptions, deductions, or credits which provide economic incentives or tax relief for qualifying taxpayers. According to the Joint Committee on Taxation, the term "tax expenditure" arises from the assumption that the goals of these favorable tax provisions could be accomplished by replacing them with a direct government expenditure. In order words, tax expenditures and government outlays are functionally equivalent. Money not taxed belongs to private persons at the sufferance of the government. The implication is that private income is property of the state, instead of belonging to those who earn it.

Special Analysis G of the Fiscal Year 1985 budget contains a list of "tax expenditures" and estimated revenue losses for Fiscal Year 1985. Tax expenditure items for individuals vary in significance. The largest item is the $56.3 billion of net excluded pension contributions and earnings. The deductibility of mortgage interest totals $25 billion, deductibility of nonbusiness State and local taxes (other than on owner-occupied homes) $21.6 billion, exclusion of employer contributions for medical insurance premiums and medical care $20.2 billion, capital gains (other than certain natural resources and agriculture) $15.7 billion, exclusion of OASI benefits for retired workers $13 billion, deductibility of charitable contributions $11 billion, deductibility of interest on consumer credit $10.8 billion, deductibility of property tax on owner-occupied homes $9.6 billion, and the deduction for two-earner married couples $6.6 billion.

These appear to be the 10 largest individual tax expenditures. In addition, there are business tax expenditures, largely concentrated in four items: $26.5 billion for the investment tax credit (except for ESOP's, rehabilitation of structures, energy property, and reforestation expenditures), $23.6 billion for accelerated depreciation of machinery and equipment (pre-1983 budget method), $7.7 billion for the exclusion of interest on public purpose State and local debt, and $5.9 billion for reduced rates on the first $100,000 of corporate income. This is not to say that there aren't many other individual and corporate tax expenditures, some valued in the billions of dollars. But the ones listed here, totalling $254 billion, are the major items listed in OMB's Special Analysis G. If a major effort is going to be made to significantly increase Federal revenues, this is where the big money is.

If the major tax expenditures for individuals were repealed or curtailed, most of the burden would fall on lower and middle-income taxpayers. Certainly, the elimination of the net exclusion of pension contributions, deductibility of mortgage interest, exclusion of contributions for medical insurance premiums and medical care, and deductibility of consumer credit interest, for example, would not significantly increase the tax burden of the rich, but would greatly increase the burden of middle and low-income taxpayers. These examples show why the idea that "tax loopholes" primarily benefit the rich is a myth.

Furthermore, many tax loopholes are designed to lessen the excessive taxation of saving and investment. For every dollar of potential additional tax revenue raised from this source, the pool of saving would decline by at least an equivalent amount. Assuming that the purpose of future "revenue enhancement" is to reduce the deficit in order to lessen credit market pressures, and not to fund increased Federal spending, any efforts to raise revenue by taxing savings more heavily is bound to be counterproductive. This can be seen in the corporate sector by the current improvement in cash flow partially due to the accelerated cost recovery system (ACRS) component of Economic Recovery Tax Act (ERTA), in concert with the economic recovery. Capital consumption allowances are a major source of corporate saving. The current improvement of corporate cash flow and business saving is widely recognized as a factor reducing credit market pressures in 1984.

Increased taxation of other forms of saving would also decrease the pool of saving. The current treatment of pension plans encourages saving, and the same is true of the treatment of IRA's and interest on life insurance savings. Changing the tax treatment of these items would be moving further away from tax neutrality, and would raise additional barriers to saving and capital formation.

Corporate Taxation

The idea that corporations are under-taxed is again in vogue. Corporate income taxes as a share of total Federal receipts have indeed declined. In 1950, 26.5 percent of total receipts were derived from corporate income taxes. By 1982 only 8.0 percent of Federal revenue came from this source.

To some, these figures make a compelling case for increasing corporate income taxation. However, there are two major reasons why the share of total receipts derived from corporate income taxation has declined. Neither reason supports the case for heavier taxation. First, there has been long-term erosion in corporate profits. Corporate profits in 1950 were 18 percent of national income; by 1982 their share had dropped to about 7 percent. Naturally, the unfavorable trend in corporate profits has reduced tax revenues derived from this source.

The other major factor explaining the decline of the share of corporate income taxes paid relative to total Federal receipts is the rising tax revenue derived from other sources. In 1950, individual income taxes contributed $15.7 billion or about 40 percent of all Federal revenue; by 1982 this had climbed to $297.7 billion or 48.2 percent of total tax revenues. Social insurance taxes and contributions (mostly social security) increased from $4.4 billion, 11.1 percent of Federal revenue in 1950, to $201.5 billion or 32.6 percent of total receipts in 1982. The rise of individual income and social security tax revenues has been a consistent trend in the last three decades.

Neutral tax treatment of corporations would permit complete expensing of capital investment, or its equivalent. Any treatment short of this should not be regarded as tax preference. In addition, the incidence of the corporate income tax has mystified economists for years. Although most recognize that corporations do not pay taxes, people pay taxes, there is great uncertainty about the distribution of the tax burden. What part workers, consumers, investors, or others may or may not pay is unclear. This leads to the question of whether it is rational to maintain a tax whose incidence is impossible to determine.

Conclusion

The current tax system is not working well and consequently is unpopular. Even after the 1981 Economic Recovery Tax Act, the tax code still penalizes saving, risk-taking, and allocative efficiency. Either a well-designed consumption tax, or a flat rate tax, would be superior by generating more saving, innovation, and economic growth while offering the potential of tax simplification. Taxation of saving and capital formation should be reduced, not increased, by any future tax reform.

IV. INTERNATIONAL ECONOMIC POLICY

In 1983 the domestic economic resurgence was not supported by the Nation's trade performance. By year end, the U.S. merchandise trade deficit reached a record high of roughly $61 billion, nearly double the 1982 level. For the second straight year, exports of both agricultural and manufactured products fell significantly, reversing the consistently positive trends of the 1970's. Services exports exhibited a similar pattern.

Worldwide trade developments this past year were also ominous. With world trade volume at a near standstill, the leaders of major free-world nations sought to bolster the international economic system. In early May at the OECD meetings, the economic ministers agreed that "within the framework of their cooperation, strengthening the open multilateral trading system is essential to support the recovery and the transition to sustained growth." Later that same month, at the Williamsburg Summit, the heads of state issued a strong statement on the need to end protectionism in international commerce and agreed to consult on ways to dismantle existing trade barriers. Yet, positive developments, such as Japan's decision to tackle the trade distorting effects of its standards and certification requirements, were a rare exception. The prevalent trend was a slide into nationalistic policies epitomized by the European Community's consideration of further trade-restricting policies as a part of its reform of the Common Agricultural Policy (CAP). Even the United States, the longtime bulwark of a free international trading system, was unable to provide leadership in dismantling trade barriers. In November, most delegates to the annual meeting of the General Agreement on Tariffs and Trade (GATT) noted the lack of progress in meeting objectives for improving the international trading system set at the 1982 annual meeting, objectives recognized at the time to be limited in scope.

The temptation in these difficult circumstances is to abandon U.S. support for an open trading system. Protectionism, however, is not in reality a serious option, but a form of economic suicide. It raises prices and limits consumer choice, particularly for those less-well-off economically. It stifles innovation by removing competition, guaranteeing a delay in the investments in technology and education needed to raise productivity levels. In the guise of a job creating policy, in the end it results in fewer jobs for Americans since other nations are bound to respond by closing their own borders to American-made products.

The employment benefits for an economy geared to global marketing should not be underestimated. In recent years, four out of every five new manufacturing jobs in this country resulted from production for export. Now, one out of every eight U.S. manufacturing jobs relates to exports, and in agriculture 40 percent of all employment is linked to exports. Services trade provides additional employment; currently the United States is responsible for 20 percent of total world trade in services. Trade already means jobs to many Americans, and our businesses have only just begun to tap this $2 trillion world market. U.S. protectionism would threaten a primary engine of future domestic employment growth—export trade.

POLICIES TO STRENGTHEN AMERICA'S INTERNATIONAL ECONOMIC POSITION

To take better advantage of trade opportunities and to lessen the risks of a protectionist folly, the United States should seek to implement policies which strengthen our trade position. Such policies should focus on the following key areas: international debt, recovery abroad, exchange rates, unfair trade practices, multinational negotiations, government organization for trade, industrial competitiveness, and industry participation in the world market.

Limiting the Adverse Effects of the International Debt Problem

A strong U.S. trade performance depends upon constructive handling of international debt problems. Statistical evidence is now available confirming the enormous effects of the debt problems of less developed countries (LDCs) on U.S. exports and jobs. The United States had a $12.9 billion deficit in 1983 with the eight high-debt Latin American countries taken as a group, compared with a $2.9 billion trade deficit in 1982. Exports to these countries fell from $26.5 billion in 1982 to $19.2 billion in 1983, a 27 percent decrease, and this followed an $8 billion decrease in exports to those countries from 1981 to 1982. Shipments dropped in 1983 across a broad range of industries: 20 percent in wood and paper products, 38 percent in nonmetallic minerals and products, and 39 percent in metals, machinery, and transport equipment. It is estimated that more than 180,000 U.S. jobs were lost in 1983 due to Latin American debt problems.

Though there have been a number of stabilizing developments over the past year—strengthening commodity prices, steady oil prices, recovery in the United States, and the implementation of stringent domestic economic programs in debt-burdened LDCs—the financial position of debtor countries remains precarious. Brazil is carrying a $93 billion debt burden and Mexico, a leading U.S. export market, has a total debt of $90 billion, of which $63 billion is owed to commercial banks in Western Europe, Japan, and the United States.

Responsible handling of the international debt problem by the banks, the borrowers, and by governments is necessary in order to minimize negative trade and financial reverberations on the U.S. economy.

Last year, the U.S. Government approved $8.4 billion in additional funding for the International Monetary Fund. This year U.S. Government policies that support domestic economic growth and maintain open markets for LDC goods are essential to further easing of the LDC debt burden. Protectionism in this country or a decline in our economic growth would deny debt-burdened LDC's needed export earnings and limit their economic growth. In addition, U.S. macroeconomic policies which lower interest rates would help these countries by reducing their interest payments.

Banks must continue to be flexible in negotiating restructured loans and should monitor the developing countries' use of borrowed funds more closely than has been the case in the past.

For their part, borrowers must continue to implement difficult austerity measures. In addition, the debt situation requires that third world countries reduce costly and counterproductive subsidy practices. Subsidies limit LDC productivity and growth, a situation debt-burdened countries can ill-afford. Equally important, subsidies create pressures in developed countries for protectionist actions which could prevent economic recovery in the LDCs.

Supporting Recovery Abroad

The United States has a strong stake in fostering recovery abroad. The U.S. job losses resulting from poor third world economic performance noted above have been compounded by the lagging recovery in the industrialized countries. In 1983, the economic growth rate for Europe (France, Germany, Italy, and the United Kingdom) was only 0.6 percent. The slow growth in Europe contributed to the dramatic decline in our trade balance with the European Community from a substantial surplus of $5.4 billion in 1982 to only $427 million in 1983.

Given the pervasive economic links among the industrialized countries, a framework of overall economic cooperation with our trading partners is a prerequisite for broadening the recovery. This framework should include close consultation on macroeconomic policies. Policy coordination should not be underestimated as a means of economic recovery, both here and abroad. Economic cooperation also precludes enactment of trade distorting domestic measures, such as the House-passed Domestic Content Bill, H.R. 1234. The Domestic Content Bill, which would require that a certain percentage of the value of an imported automobile be sourced in the United States, is a blatant violation of this country's international legal obligations and a grave threat to world economic recovery. It would cost more jobs than it creates. The Congressional Budget Office estimates that by 1990, the domestic content legislation would eliminate roughly 104,000 jobs in the U.S. export sector against the creation of 38,000 jobs in the automatic sector.

Stabilizing the Value of the Dollar

The dollar rose to unprecedented levels on exchange markets in 1983, hindering U.S. export sales and intensifying import pressures in the domestic market. For example, between December 1982 and December 1983, the dollar appreciated 24 percent against the French franc and 14 percent against the Deutsch mark. On a trade-weighted basis, the appreciation was 11 percent over the same period. These 1983 increases brought the total dollar appreciation since December 1980 to 84 percent against the French franc, 38 percent against the Deutsch mark, and 46 percent on a trade-weighted basis. The dollar appreciation contributed to increases in the value of U.S. imports by $11 billion and reductions in the value of U.S. exports by $24 billion since 1980. Since every $1 billion in exports accounts for approximately 25,000 jobs, it is possible that 600,000 jobs have been lost in export business alone, partly as a result of the high value of dollar.

The growing trade and current account deficits and improving U.S. growth rate presage a decline in the value of the dollar. Several factors, however, are working against these economic fundamentals, including the attractiveness of the United States as a safehaven for foreign investments, low inflation and relatively high real U.S. interest rates. These factors attract substantial capital to this country. The inward flow of capital raises the demand for dollars and keeps the value of the dollar high.

Policies aimed at stabilizing the value of the dollar must be capable of providing long-term results. Exchange market intervention should be used only in conditions of severe distortion because intervention is exteremely costly and is likely to provide only a short-term, if any, market effect. The basic economic factor that must be addressed—interest rates—is related to macroeconomic policies, both monetary and fiscal.

Monetary and fiscal policies necessary to stabilize the value of the dollar are outlined in Chapter I and II of this Report. Interest rates are most clearly affected by monetary policy. Over the last few years, the Federal Reserve Board has broken the inflationary spiral of the 1970's—a development of critical importance to the long-term competitiveness of U.S. industry. Without jeopardizing its success on inflation, the Federal Reserve should now assure that the supply of money is sufficient to prevent upward pressure on interest rates. In addition, many people believe that fiscal policy, particularly the large projected budget deficits, has been a recent source of pressure on interest rates. Unfortunately, Congress has been unwilling to make the spending cuts necessary to bring the deficits under control and help to restore the thousands of jobs lost as our export sales have faltered.

While the adverse effects of current exchange rates on U.S. trade are attributable for the most part to the unprecedented value of the U.S. dollar, our trade performance has also been affected to some degree by the undervaluation of the Japanese yen. Although the value of the dollar in terms of yen fell slightly in 1983, between 1980 and 1983 the dollar rose by roughly 14 percent against the yen, from 203 yen per dollar to 231 yen per dollar. A high point occurred in November 1982, when one dollar equaled 278 yen, 21 percent over the December 1980 level.

In November 1982, President Reagan reached an agreement with the Japanese government regarding steps that government would take to internationalize the yen. A number of these steps—easing guidelines on the issuance of yen-denominated bonds abroad, lowering the mininum denomination of certificates of deposit, and abolishing restrictions on the yen forward market—should help reduce the global demand for dollars and raise the value of the yen. The United States should press the Japanese to follow through on these commitments and should seek to build on them. Probably the most significant step the government of Japan could take would be to encourage the denomination of a large share of Japanese exports and imports in yen. It is estimated that in 1981 only 2 percent of Japan's imports and 37 percent of its exports were denominated in yen. Such a step would greatly increase the demand for yen causing the value of the yen to strengthen.

Countering Unfair Trade Practices

This country cannot easily avoid unfair trade policies if other countries do not make similar commitments. We must increase our efforts to combat unfair practices on the part of our trading partners. Predatory trade measures (e.g., domestic subsidies, export aids, and cartel arrangements) deny U.S. producers sales at home and abroad and should be removed.

The United States should develop careful and measured responses designed to restore our legitimate competitive opportunities rather than implemeting actions that will promcte a beggar-thy-neighbor trade war. On this point, we note that there is a danger in the unilateral development and enactment of new trade laws. Historically, U.S. laws to counter foreign unfair trade practices, such as dumping and subsidization, have been based on painstakingly-negotiated international agreements. Because of their link to these agreements, our trading partners have in nearly all instances refrained from retaliating against import restrictions imposed under these statutes. Unilateral trade laws risk retaliation and invite other countries to develop their own unilateral trade rules, which well could run counter to U.S. interests.

Improving the International Trading System

As the Administration has recognized, there is a need for multilateral trade negotiations. A number of key issues were left unresolved in the last round of international trade negotiations, the Tokyo Round. Principal among these were rules for trade in agricultural products an area that has become increasingly contentious, and general agreements on procedures and criteria to be followed when import restraints are taken to "safeguard" a domestic industry from increases of fairly-traded imports. The absence of real international consensus on safeguards encourages countries, the United States included, to bypass current trade rules. In addition, the GATT, which governs trade among most nations, does not deal with trade in services or adequately address investment issues, such as performance requirements and local content rules. Another important area which merits special attention in new trade negotiations is high-technology trade. Discussions should begin in the GATT on industry "targeting" practices.

Today's world economy is characterized by tumultuous change--the constant appearance of new products, services, and processes, and rapidly shifting comparative advantage between countries. In this dynamic environment, international trade agreements—tariff and nontariff—can quickly become outdated.

The current rapid pace of economic change demands a commitment to an on-going, multilateral trade negotiating process. This is the best way to assure that the United States receives reciprocal benefits for its trade concessions and the advantages of trade expansion.

Fortunately, support for negotiations to strengthen the trading system is growing. The European community is now backing international consideration of services trade issues and Japan has called for a new GATT negotiating round. United States leadership has fostered this growing consensus in favor of negotiations. In 1984, the Administration should continue to press our trading partners to undertake the necessary preparatory work for new negotiations to strengthen the multilateral trading system.

Reorganizing the Government's Trade Bureaucracy

Trade leadership is now split between the Department of Commerce and the U.S. Trade Representative. The Department of Commerce provides trade analysis, implements trade agreements, and promotes exports. The U.S. Trade Representative manages trade negotiations and trade policy. This split is in many respects artificial. Where does analysis end and policymaking begin? When does negotiation stop and implementation start? The division of trade leadership between these separate agencies results in management inefficiencies, turf battles, and ad hoc, reactive, and sometimes contradictory government trade policies. No one knows where the trade buck stops. Moreover, under this trade organization, trade policy often is merely the residual of decisions made in furtherance of other disparate goals. Trade does not have "clout" when national priorities are established.

The United States can increase its effectiveness in multilateral trade negotiations, in enforcement of domestic trade laws, and in the coordination of macroeconomic policies with our trade interests by restructuring our government organization for trade. The Administration has proposed the creation of a separate cabinet Department of Trade to remedy the deficiencies in our current trade organization.

Enhancing Our Industrial Competitiveness

American successes in today's globally-interdependent world depends upon adjustment by the private sector. Government's role should be to create a favorable environment for private sector adjustment to the new trade realities. Policies to foster such an environment are discussed throughout this Report and a detailed discussion of industrial competitiveness follows this chapter. Our basic approach is to recommend a combination of general policies (e.g., macroeconomic, antitrust, regulatory, research and development) and policies geared to individual adjustment (e.g., retraining, job search, and relocation). This approach could be called "growth policy." We reject a heavy reliance on approaches—such as industrial policy—which emphasize sectoral policies. An emphasis on industry-specific policies, particularly the selection of industry "winners and losers," is likely to lead to increased protectionism, costly pork-barrel approaches, and a degree of government planning that is an anathema to the American public. As a result, it would mean slower adjustment and a lower standard of living in this country. It is "growth policy," not "industrial policy," that has the potential to spread and increase our national prosperity.

The use of import protection to promote adjustment should be considered only in the most serious circumstances because government intervention to protect one sector of the economy can harm other sectors. This is why the legal standard for protection from fairly-traded imports is difficult to meet. This past year, only two industries received relief under this standard—speciality steel and motorcycles. There is, moreover, a growing consensus that when relief from imports is provided, the industry involved, and its workers, should be expected to undertake specific commitments that would enhance the competitiveness of that industry.

Broadening American Participation in the World Market

A final area that should not be overlooked in assessing the reasons for our poor trade performance is the reluctance of American businesses to participate in international markets. Only a relatively small number of U.S. companies account for most manufactured exports: Five companies account for 13 percent; 50 exporters account for 34 percent and over 60 percent is accounted for by about 1,000 exporters. It is further estimated that only about 10 percent of the 300,000 manufacturing companies in this country are exporters. Given this situation, our government leaders must continue to urge American businessmen to enter the competition for world markets. American businesses can no longer afford to produce primarily for this country, with only the leftovers shipped abroad.

CONCLUSION

Today, the world economic system is at a crossroads. Nations may strengthen and support the system to promote world prosperity or they may turn on it and revert to a morass of beggar-thy-neighbor policies reminiscent of the 1930's. Much depends on U.S. leadership. To remain a world trade leader, the United States must continue to deal with its own trade problems constructively.

In summary, a constructive approach to trade would first and foremost avoid protectionist policies. Instead, the United States should implement policies to strengthen our economic recovery and lower interest rates, bolster industrial competitiveness, support the multilateral trading system, and encourage American participation in world markets. Consultation with our trading partners should be pursued to expand free trade, but at the same time, our trading partners should be put on notice that our domestic trade laws will be vigorously enforced. Finally, we should make trade a clear national priority by better coordination and concentration of our trade agencies.

V. INDUSTRIAL COMPETITIVENESS

Industrial policy advocates have been critical of the Nation's industrial performance, but their calls for more government intervention are ill-founded. A review of long-run employment, trade, output, and productivity trends reveals that the United States is not deindustrializing. The American economy is considerably different today than it was following World War II, because of its flexibility and dynamism, but the U.S. economy has not lost its competitiveness.

Manufacturing output has held relatively steady at about 24 percent of GNP from 1950 to the present. Also, the perception that millions of workers are being displaced in manufacturing by foreign competition is simply untrue. Total jobs in manufacturing have actually increased each decade since the 1950's.

What is happening in the American economy is that long-term structural changes are being reflected in rising fortunes for some industries and declining fortunes for others. Exports have risen as a percent of GNP to a current level of about 12 percent. Manufacturing output has kept pace with the national economy, but manufacturing jobs have been declining as a percent of total employment. These structural shifts reflect higher productivity growth in the export and manufacturing sectors and shifts in consumer preferences. They do not reflect a loss of U.S. competitiveness in international markets. Foreign competition is important, but it is not a major causal factor in the long-term transformation of the American economy.

The long-run resiliency of the American economy is best revealed in the data on job creation. A comparative analysis of long-term job creation among the industrialized nations is presented in Table V.1. In the United States, total employment expanded by 20 percent from 1960 to 1970 and by 25 percent from 1970 to 1980. About 33.3 million more Americans were employed in 1980 than in 1960. Of the industrialized nations, only Canada outpaced the United States in the rate of net total job creation. A large percentage of these jobs were filled by women, minorities, and youth as they entered the labor force for the first time in record numbers.

The 1981–1982 recession reduced total employment, but employment growth has since resumed at a record clip. In 1983, four million net new jobs were created as the American economy surged ahead. This suggests that labor markets will continue to be robust in the future.

Job growth in the service sector has outpaced job growth in the manufacturing sector, but U.S. manufacturing employment is not declining. In 1979 more workers were employed in manufacturing than in any previous year. By 1982, manufacturing employment slumped as a result of the recession, but it has rebounded strongly since then. Current trends suggest that employment in the manufacturing will soon surpass the 1979 level. In addition, job growth in the manufacturing sector in the United States outpaced that in Japan and most other major industrialized nations by a wide margin (See Table V.1.). There is no evidence from the data that the United States is a net exporter of manufacturing jobs to the rest of the world.

TABLE V.1.—TOTAL AND MANUFACTURING JOB GROWTH IN THE UNITED STATES, JAPAN, AND OTHER INDUSTRIALIZED NATIONS

[1960 to 1982]

	1960 to 1980	1970 to 1980	1980 to 1982
	Percent change in total employment		
United States	19.5	24.9	0.3
Canada	32.7	34.5	−.8
Australia	N/A	16.0	2.2
Japan	14.8	8.7	1.8
France	9.4	3.9	−.9
Germany	1.6	−1.4	−2.4
Great Britain	2.7	1.3	−6.3
Italy	−4.9	7.0	.0
Netherlands	12.4	1.9	−3.1
Sweden	7.1	9.8	−.3
	Percent change in manufacturing employment		
United States	20.1	5.8	−7.5
Canada	20.2	19.1	−8.5
Australia	N/A	−7.3	−2.3
Japan	45.8	−.9	.8
France	7.8	−3.8	N/A
Germany	9.8	−9.5	N/A
Great Britain	−4.6	−18.1	−16.0
Italy	10.0	3.6	−3.8
Netherlands	4.0	−19.7	N/A
Sweden	−5.0	−3.7	−7.7

Source: Bureau of Labor Statistics, Statistical Supplement to International Comparisons of Unemployment Bulletin, September 1983.

Another argument often heard in the national debate over industrial competitiveness is that the problem of long-term structural unemployment is particularly acute in the United States. A rapid shift in the structure of the American economy away from manufacturing is allegedly the culprit.

As we have seen, jobs in the manufacturing sector are not disappearing. Equally wrong is the impression that the United States has a severe problem with long-term structural unemployment. Short-run unemployment tends to be higher in the United States than it is abroad, but long-term unemployment is dramatically lower. The brisk pace of U.S. job creation and a larger percentage of American workers changing jobs annually accounts for the differential. In a recent Monthly Labor Review article, Janet Norwood, Commissoner of Labor Statistics, said:

> In the United States, even during the recent period of recession, the mean duration of unemployment is only about 4 months; in Europe, the average ranges from 7 to 10 months for most countries. On average, in 1982, 1 of 3 of the British and French unemployed were out of work

> for 1 year or longer. In contrast, fewer than 1 of 10 of the American unemployed had been jobless that long.
>
> The point is that American workers tend to move into and out of employment and unemployment, whereas, European joblessness tends to reflect a much larger group of long-term unemployed.

The displaced worker problem in the United States is serious and requires public attention, but apparently it is not as acute as some would have us believe. Marc Bendick of the Urban Institute, in testimony before the Joint Economic Committee, estimated the number of permanently unemployed displaced workers to be about 100,000. These are workers who lose their jobs because of structural changes and who are unlikely to find jobs even as the Nation's economy recovers. The Congressional Budget Office estimated the number of structurally unemployed in 1983 to be between 100,000 and 2.1 million. While the experts cannot agree on the magnitude of the structural unemployment problem, a conservative estimate is consistent with Commissioner Norwood's analysis of a comparatively low, long-term unemployment rate in the United States. The data do not support the claim that structural change is causing massive permanent unemployment.

The misconception that the United States is deindustrializing is based on the mistaken belief that the U.S. industries are no longer competitive in world markets. The growth of U.S. merchandise trade deficits to $28 billion by 1981 and $61 billion in 1983 are frequently cited as proof that the United States is losing its competitive edge. Similarly, the post-World War II decline in the U.S. share of total world exports is cited as additional proof that the American economy is no longer what it used to be.

A closer examination of the U.S. trade deficits over the past decades reveals no evidence of an erosion of U.S. competitiveness. In fact, the data presented in Table V.2 reveals a strengthening of U.S. competitiveness, since growth in U.S. merchandise exports has exceeded growth in U.S. merchandise imports (net of fuel and energy imports). Over the 1973 to 1981 period, the value of the U.S. trade surpluses in agriculture, capital goods, chemicals, military goods, and other tradeable products expanded by $64.7 billion, and imports (excluding fuel and lubricants) were up only $29.4 billion. The fact that the value of fuel imports increased $65 billion over this period resulted in a merchandise trade deficit of about $28 billion by 1981. Had not U.S. competitiveness in agriculture and manufacturing increased, the U.S. merchandise trade deficit would have been much larger. Fortunately, the surplus in service trade, including income from investments abroad, was sufficiently large to create a surplus in the balance of trade in goods and services of $11.5 billion in 1981. Since 1981, the balance of trade in goods and services became negative as a result of the world-wide recession, the strong dollar, and international financial developments. This deterioration in U.S. trade performance is a problem that can only be effectively addressed with appropriate fiscal and monetary policies, as discussed in the previous chapters.

TABLE V.2.—*Changes in U.S. merchandise trade balances, 1973 to 1981*

	Billions
Surplus sectors:	
Agriculture goods	$16.3
Capital goods	31.8
Chemicals	8.8
Military equipments	2.2
Other	5.6
Deficit sector:	
Other industrial supplies	−7.5
Consumer goods	−14.4
Automotive products	−7.2
Fuel	−65.0

Source: Department of Commerce.

While overall U.S. competitiveness has not declined, the composition of U.S. trade flows has changed substantially. Within the manufacturing sector, U.S. exports of high-tech products (including capital goods and chemicals) expanded while U.S. imports of autos, steel, consumer electronics, color TVs, and other low-technology products increased.

The shift in U.S. trade patterns mirrors domestic changes in the manufacturing sectors. The R&D intensive and high-tech oriented manufacturing sectors have surged ahead while many of our basic goods industries (e.g., steel) contracted. As we have seen, the manufacturing sector as a whole performed quite well as resources flowed to more efficient uses in those international markets where the United States holds a competitive edge.

The transformation of the American manufacturing sector has been an on-going process for many years. It has not been a sudden, dramatic change. The speed of the adjustment has been sufficiently slow to allow employment to grow in the high-tech and service sectors and shrink in the low-tech sectors without causing massive structural unemployment. Some areas of the country are experiencing severe unemployment, because of heavy concentrations of declining industries, but the national economy is sufficiently large and diverse to absorb economic changes without major disruptions and dislocations.

Undeniably, the U.S. share of total world trade has declined since World War II when the United States enjoyed worldwide economic hegemony. Also, the U.S. share of world GNP declined over this period from almost 50 percent in 1945 to about 25 percent today.

The decline in U.S. world shares of output and trade, as we have seen, does not represent deindustrialization. What it does represent is a U.S. growth rate below the average growth rate of the other industrialized nations. Table V.3 presents comparative long-term GNP growth rates for the United States, Japan, and other industrialized nations. The higher early post-World War II growth rates of the other industrialized nations reflects a catching up with U.S. technology. In the more recent years, as the technology gap narrowed, there has been a convergence in economic growth rates among the world's industrialized nations.

TABLE V.3.—GROWTH RATES IN REAL GROSS NATIONAL PRODUCT, 1960 TO 1983

[Percent change]

	Annual average				1981	1982	1983
	1961–65	1966–70	1971–75	1976–80			
United States	4.7	3.2	2.6	3.7	1.9	−1.7	4.8
Canada	5.7	4.8	5.0	3.1	3.8	−5.0	3.8
Japan	10.0	11.2	4.6	5.0	3.2	2.5	2.0
France	5.8	5.4	4.0	3.3	.2	1.5	.5
West Germany	5.0	4.2	2.2	3.5	.2	−1.2	1.2
Italy	5.2	6.2	2.4	3.8	−.1	−.3	−1.5
United Kingdom	3.1	2.5	2.1	1.6	−2.0	.5	2.5

Source: Department of Commerce, IMF, OECD, and CEA.

Industrial policy advocates would have us believe that the overall sluggish growth performance of the U.S. economy is the result of unfair competitive practices of other nations. Actually, the growth rates of other industrialized nations have fallen more sharply from their 1961 to 1965 rates. Moreover, the characteristically low U.S. growth rate can be explained by examining Table V.4. In the United States, saving and investment as a percentage of GNP has been consistently lower than in the other industrialized nations. The willingness of the other industrialized nations to commit a larger share of their national resources to economic growth largely explains the differentials in overall growth performance. The Republican Members maintain that it is the lack of a U.S. commitment to long-term economic growth that accounts for our declining share in world markets.

TABLE V.4.—GROSS FIXED CAPITAL FORMATION AND SAVING AS A PERCENT OF GROSS DOMESTIC PRODUCT FOR SELECTED YEARS

	1962	1970	1978	1982
Gross investment as a percent of gross domestic product				
United States	17.6	17.6	19.5	16.6
Japan	32.9	35.5	30.8	29.6
Germany	25.7	25.5	20.8	20.5
France	21.4	23.4	21.4	20.5
United Kingdom	16.8	18.5	18.0	15.4
Italy	23.7	21.4	18.7	19.0
Canada	20.5	20.8	22.2	21.1
Gross savings as percentage of gross domestic product				
United States	18.9	18.1	20.3	15.9
Japan	34.8	40.2	32.3	31.6
Germany	27.3	28.1	22.8	21.5
France	24.6	26.2	22.6	18.5
United Kingdom	16.9	21.5	19.4	16.9
Italy	26.0	24.2	22.4	18.8
Canada	20.8	21.2	20.1	19.0

Source: OECD Economic Outlook.

There are many reasons why the United States systematically invests a smaller portion of its resources into capital formation. A tax system that encourages consumption and discourages investment has no doubt been a major factor. As discussed in Chapter III, the U.S. Tax Code results in double taxation of saving and double taxation of corporate dividends. Saving is taxed first as income and later the income from investment of savings is taxed. The deductibility of interest on housing and consumer loans provides an additional bias against saving. Corporate earnings are taxed first as profits and then as dividends. Inflation compounds the problem by forcing individuals into high tax brackets and by inflating profits. The net effect of the tax system is a lower rate of return on saving and investment. The important lesson to learn from Table V.4 is that the United States must pursue policies to encourage additional saving and investment if it is to achieve a higher sustained long-term economic growth rate.

Critical to the debate over long-term U.S. competitiveness is the issue of productivity growth. U.S. productivity growth held relatively steady after World War II, but beginning in 1973, following a worldwide trend, it took a noticeable drop. After reviving somewhat in the late 1970's, productivity growth again collapsed and remained at its 1977 level through 1982. Critics frequently sight these trends in U.S. productivity growth as just another indication of declining U.S. competitiveness.

Actually, the outlook for productivity growth is not nearly so bad as it seems. Productivity growth showed a healthy gain of 3.5 percent in 1983 and it promises to remain at a robust level in the years to come. To see why, it is helpful to examine some of the major factors behind the abrupt slowdown in productivity growth after 1973, and how these factors will affect productivity growth in the future. Economists are in general agreement that the following factors account for much of the productivity slowdown:

Growth in capital per worker declined sharply in the 1970's. This occurred in spite of a slight increase in the rate of capital formation because of the rapid growth in the labor force as the "baby boom" of the post-World War II period resulted in a "labor force boom." The problem was not so much that capital formation was low, but that labor force growth was high. The Republican Members believe that the resulting reduction in growth in capital per worker was an important factor in the decline in productivity growth.

The escalation of tax rates and government spending as a percentage of GNP created a disincentive to invest in long-term productivity-enhancing projects.

The proportion of youth, women, and minorities in the labor force increased substantially during the 1970's. The labor force mix exerted downward pressure on productivity growth because workers in these groups had less experience.

Government regulations probably added to the slowdown in productivity growth as investment resources were devoted to meeting environmental, product safety, and occupational health standards.

The "energy crisis" probably also affected productivity growth because a portion of the Nation's capital resources and technology were made obsolete by the new energy requirements.

A decline in labor and capital mobility, associated with high unemployment and excess capacity, probably likewise contributed to the slowdown in productivity growth. A high employment economy encourages labor and capital mobility and provides the business community an opportunity to increase productivity by employing labor and capital more efficiently.

Although economists are unable to agree on the relative contribution of these factors to productivity growth, they do agree that they are important. If this is correct, then the future outlook for productivity growth looks encouraging. Many of the factors that contributed negatively to productivity growth in the last decade or so are now likely to exert a positive influence. First, growth in the Nation's labor force will decelerate since the baby boom has run its course. Second, lower tax rates, reduced government spending, and the vigorous recovery that is now underway will result in an increase in the rate of capital formation. As a result of these two factors, capital per worker should reverse its downward trend and turn sharply upward. The natural maturing of the labor force is another demographic trend favoring a resumption of productivity growth.

Also, the explosive growth of venture capital and high-technology activities, including an expansion of commercial R&D, suggests that improvements in the quality of capital will be substantial. American business is taking a long view and investing in new processes and new product technologies in order to take advantage of emerging market opportunities. The result is that technical progress should resume its long-term historical role as a major contributor to productivity growth in the years ahead.

Moreover, the policy environment has been stabilized in recent years with much greater emphasis on promoting competition through deregulation and international trade. Joint ventures in R&D and in production are being encouraged in those cases where scale economies are necessary for competition. Also, much of the hard work of bringing down inflation to permit more orderly economic growth is behind us. The Republican Members believe that a policy environment that relies on competitive markets is essential to spur technological innovation, long-term capital formation, and productivity growth.

Other factors, like environmental regulations and high energy costs, are still with us; but they are not likely to be a major burden on productivity growth in the near future. Also, much of the new capital requirement to meet energy and environmental objectives is already in place. More capital market resources are now free to flow into productivity-enhancing investments than in the past.

Other qualitative factors are important in suggesting an abrupt turnabout in long-term U.S. productivitity growth. American management has done much to shift emphasis to product quality, cost cutting, and ways to develop incentives to encourage worker productivity. Also, labor has made painful concessions at the bargaining table that should encourage productivity growth.

Another positive factor is the recent attention given to the quality of education in America. The outcome of this public awareness of the need to improve educational quality and overcome major deficiencies in math and science training is likely to be a better educated and more productive labor force in the 1980's.

Finally, the economic development activities of State and local governments are likely to improve productivity growth. State and local governments are placing much more emphasis in recent years on the role of technological progress in the development of their regions. This effort is being translated into more support for R&D activities, improved university-business linkages, better education, and more efficient land-use regulations. The central thrust of these actions is to remove technological and labor market barriers to economic development and allow the market to exploit new opportunities. To the extent that they are successful, these State and local government actions will be another of the many positive factors pointing to a resumption of productivity growth in the United States.

The expected resumption of productivity growth, while it is good news, should not be misconstrued as a painless way to accelerate economic growth and achieve a higher level of per capita income. As stated, the Republican Members believe that a high rate of economic growth will require that the Nation make a larger overall commitment to capital formation, technological change, and human resource development.

In conclusion, the Republican Members believe that arguments for more government intervention into the economy must be rejected because they are based upon a misrepresentation of the facts about long-term U.S. industrial performance. More government intervention is no substitute for macroeconomic and trade policies that promote competition and a healthy, dynamic labor market. Vigorous job creation is the best way to mitigate the adverse effects of structural change.

Government assistance in the form of training, retraining, job search, and relocation allowances, to help those who are unable to adjust, is necessary. The Republican Members believe that the recently enacted Job Training & Partnership Act goes a long way in providing the needed assistance. We believe that government policies ought to be aimed at helping individuals and families in need and at facilitating the adjustment process. Quotas, tariffs, and direct subsidies to industry—the favorite tools of industrial policy advocates—should be avoided because they will only reduce U.S. competitiveness, retard job creation, and increase the cost of structural adjustment for American workers and their families.

VI. REGULATORY REFORM

One of the fundamental roles of government is to intervene when the workings of the market are in conflict with public policy or desired social goals. The traditional response of the U.S. Government when this occurs is to impose regulations designed either to modify the behavior of firms in an industry or to alter the structure of the industry. In contrast to other radical forms of government intervention, such as nationalization of an industry, divestiture of a monopoly, or economic planning by central control, regulatory action is relatively mild and tends to preserve some market elements. Despite this, regulation can result in major economic and social costs borne by the public.

Regulatory actions inherently are arbitrary and political in nature. Hence, they inevitably are controversial. The U.S. economy is regulated to the extent that the American public is somewhat skeptical of "big business" and "big labor." However, the public is equally concerned about "big government," and thus a healthy check and balance system to prevent abusive power or exploitation appears to exist. The public requires justification for regulation because ideals such as individual rights, satisfying consumer preferences, and free enterprise are held in high regard. In addition, the merits of competition are recognized and accepted widely in achieving and sustaining these goals associated with freedom.

Because public opinion changes, the perceived need for, and degree of regulation changes over time as well. Prevailing economic conditions and technological advances influence the level of regulatory activity considered appropriate. Also, as the U.S. economy grew dramatically during the past century, so has the amount of regulation. In the 1970's business began to protest regulations which impeded economic efficiency or failed to accomplish their intended goals. Eventually, the public became aware of how regulations were affecting their preferences and pocketbooks.

It is recognized that regulation is necessary when the public desires to allocate resources or distribute income in a manner different from the result of market forces. Typically, it is defined in two categories. "Social regulation" refers to government requirements or standards of conduct regarding health, safety, environmental protection, and the like. "Economic regulation" refers to governmental control of prices of, and entry into, an industry which in turn influences output as well. "Deregulation" does not necessarily refer to the absence or elimination of all regulation or governmental control. Rather, its common usage alludes to the relaxation, rationalization, reduction, or revision of regulation.

Government intervention is invoked when economic activity produces undesirable results such as abuse of monopoly power, market failure, instability, conflicts with public policy objectives, and "externalities." An externality exists when an economic transaction between a buyer and seller, or producer and consumer, affects a third party as well. A positive externality provides a benefit to the third party. Such is the case in the telephone industry; as more subscribers join a telephone network, all subscribers benefit by having additional people to call. A negative externality involves a cost to the third party. For example, air pollution caused by an industrial process is endured by more people than just those purchasing the product manufactured by that process. If the price of that product does not reflect the cost of safeguarding the environment, the buyer receives a "windfall" benefit at the expense of others. Eliminating externalities is an important function of social regulation.

A growing amount of evidence suggests that governmental regulators too often do not have full regard for the economic consequences of their actions. In recent years, fortunately, cost-benefit analyses and improvements in the monitoring techniques of the various regulatory agencies have been somewhat helpful in achieving goals at a lower cost to the economy, but further progress is possible. This is true especially with respect to social regulations such as pollution control. Establishing pollution abatement levels by requiring all industries to reduce proportionately may be, and often is, technically and economically inefficient. The same result can be accomplished at less cost if the economic concept of aligning marginal costs and marginal benefits were employed.

While the government's legitimate response to market failure is regulation, society's only recourse in the event that government intervention also fails is to modify that governmental action. And, regrettably, the government has proven to be slow in correcting its misguided actions. Over the years, the regulatory burden has increased dramatically. Complicating this mounting problem is the difficulty of a dual Federal/State regulatory structure. At the Federal level alone, over 50 agencies have some regulatory authority over individuals or industry, at an administrative cost of some $8 billion a year to taxpayers. But that is not the major financial burden. Some independent studies have estimated that regulatory compliance costs total more than $100 billion annually.

The decade of the 1970's was a time of rapid technological advance, changing consumer demand, uncertain domestic economic prospects and a growing global economic interdependence. Even in the best of economic circumstances, let alone under these conditions, a free market requires (1) flexible prices to ensure that resources are put to their best uses, (2) easy entry into, and exit from, industries so that resources can be utilized where consumer demand is present, and (3) cooperation between government and industry so that the United States can compete with other countries in world trade. Clearly, the two most common forms of government economic regulation—price control and entry restrictions—were contributing to the economy's deteriorating performance.

Inflexible regulatory restraints proved harmful during this time, and by the late 1970's and early 1980's, political forces were strong enough to reverse the longstanding trend of the increasing regulatory burdens. Although some studies show beneficial results from deregulation, the evidence will not be conclusive for a number of years.

Because changes in regulatory practices will result in both short- and long-run price and resource adjustments, the political arena will endure considerable criticism from citizens who benefitted from regulation. Even if society on the whole benefits greatly, a sizeable portion of the population may be affected adverse. Since regulatory matters are resolved in a political setting, justifying a new distribution of benefits and burdens is of crucial importance to the success of sustaining the deregulation trend. Defending regulatory change on economic efficiency grounds is not sufficient to ensure its political palatability.

Deregulatory efforts are underway in major sectors of the economy. The transportation sector has undergone regulatory change in railroads (1976 and 1980), aviation (1978), trucking (1980), and busing (1982). The financial sector has been affected by legislative and agency changes in 1978, 1980, and 1982, and comprehensive regulatory and structural changes are slated for consideration in 1984. The telecommunications sector has been altered by more than regulatory change; in 1982 the Justice Department ordered the restructuring of the entire industry. The following subsections highlight these events.

FINANCIAL SERVICES

The insurance, securities, and depository institutions industries are among the most regulated in the economy. In general, the regulation imposes entry restrictions and requirements, price controls, and portfolio management rules. Insurance operations are regulated principally at the state level.

Banks, savings and loan associations, and credit unions are regulated by the Federal Reserve System, Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Savings and Loan Insurance Corporation, Federal Home Loan Bank Board, National Credit Union Administration and indirectly by the Depository Institutions Deregulation Committee. The securities industry is governed in part by the Securities and Exchange Commission and in part by its own trade associations.

Regulatory reform is occurring or has occurred on three fronts: the organization of regulatory agencies, the deregulation of depository restrictions, and restructuring of regulations separating financial sectors.

Because of the large number of agencies involved, the Reagan Administration has recommended a reorganization of the way the Federal Government oversees banking activity. Under the leadership of Vice President Bush, the Task Group on Regulation of Financial Services has proposed a streamlining of the oversight process. If approved by Congress, the Office of the Comptroller of the Currency would be transformed into a new Federal Banking Agency which would regulate all national banks except for about 35 large bank holding companies in a special "international class." Those bank holding companies and all State chartered banks would come under Federal Reserve authority. The Fed would forfeit its rulemaking power in exchange for a veto option over the Federal Banking Agency's rules. The FDIC would relinquish its oversight of State banks which are not members of the Federal Reserve, but it would retain its responsibility for troubled bank oversight and for deposit insurance, a role of increasing importance in recent years in light of several banking failures and proposed changes in service offerings of banks.

No industry bears the marks and memories of the Great Depression more than banking because so many of the rules defining it were inspired at that time. Some analysts believe that much of this regulation can be discontinued that excessive competition was responsible for the collapse, and that inappropriate monetary policy deepened the depression. Deregulation supporters, therefore, contend that current regulation is unduly restricting the banking industry at the expense of both savers and borrowers.

Banks are affected substantially by geographic restrictions, prohibitions on offering securities and insurance services, and strict portfolio rules. Along with restrictions on interest rates, the banking industry has been penalized during a time of economic strees, changing consumer demand, and the advent of considerable competition from nontraditional sources.

Geographic restrictions were imposed to avert concentration of assets and power. While interstate banking prohibitions may prevent consolidation at the national level, such rules can create degrees of concentration at the State or local level by virtue of discouraging outside competition. In addition, these rules are most effective with respect to the deposit side, rather than the loan side, of banking. States have authority over bank branching and interstate presence, and many have liberalized their laws to allow interstate-based financial interests inside their boundaries. From a theoretical perspective, the economy is facilitated by a nationally integrated money market which would ensure a fluid movement of money resources to their best uses. Geographic restrictions tend to impede that mobility.

An accounting of changes in the financial sector provides excellent case studies showing that market forces "naturally" find ways to circumvent regulations which do not serve the interests of consumers. The uncertain economic conditions of the late 1970's, inflation particularly, required savers to be interest-rate sensitive in order to protect their funds from depreciation in real terms. Since banks were restricted by law from offering higher rates on relatively small amounts, alert savers sought alternative uses of their deposits. As a result, over $200 billion was diverted to unregulated money market mutual funds in just a few years. Eventually, regulators were obliged by law to deregulate interest rate ceilings to allow banks to compete for deposits. Now that they can compete, money market fund assets have dropped considerably.

A stronger example of regulatory circumvention is evident in the "nonbank" controversy. Because of a definition "loophole," many corporations, typically in mutual funds management, credit cards, and insurance, have purchased banking operations. Those acquired banks' activities then are altered so that they either do not take deposits *or* do not make commercial loans. By these alterations, they escape regulation which defines a bank as taking demand deposits *and* making commercial loans. In the absence of Federal authority, these "nonbanks" are free to engage in services that are desired by consumers and that banks cannot offer. Clearly, traditional banks are at a disadvantage.

Some States have banking laws which are less restrictive than Federal law. A number of financial institutions are attempting to offer new services by acquiring State-chartered banks in States with laws and business climates favorable to their intentions to expand. The Federal Reserve has regulatory authority over member State banks, and thus far has been successful in thwarting such efforts. The Office of the Comptroller of the Currency, too, has established a moratorium on "nonbank" charters.

These creative attempts to expand and diversify the financial services of banks have not been futile even if Federal restrictions have prevailed by and large. Some banking interests with detectable public support have shown their determination in changing regulations and thereby offering consumers better service.

Such changes in the banking industry are not entirely beneficial, however. Insurance underwriting, securities underwriting, and brokerage could lead to conflict of interest or concentration of powers and entail considerable risk. Historically, these activities have been prohibited because banks are charged with the awesome responsibility of managing money flows. Banks are the custodians of demand deposits, the standby source of liquidity for all other institutions, and the transmitting medium through which monetary policy is accomplished.

Certainly our economy cannot afford to expose the money system to conflict of interest resulting in undue risk. Various financial services historically have been separated to maintain public confidence, reduce risks, and prevent concentration. While these accomplishments must be preserved, the current regulatory setting requires modification. First, the rules are not uniform. Insurance, securities, and real estate firms have been allowed to engage in banking activities but banks are forbidden to become involved in other services. Second, if consumer demands are to be accommodated, then "one-stop" financial centers will continue to grow, and banks could offer service in competition with nonbanks.

Since banks serve a vital role in the monetary system, many safeguards would need to be implemented to sustain a sound and secure banking environment. In addition, since deposits are federally insured, taxpayers and deposit holders do not deserve to subsidize or rescue unprofitable undertakings of a bank. Some say the "separate subsidiary" concept of keeping services distinctly divided and auditable may be the appropriate way to allow the diversity consumers want, and banks are willing to offer, while retaining accountability and safety. Others say the separation of banking and commerce, as a matter of law, is sound public policy which has served the country well, and with some routine maintenance can and should be preserved. The safety and soundness of the banking system in the present market would seem to call for some modification of present laws regulating financial institutions.

TELECOMMUNICATIONS

Today's telecommunications industry is the product of technology and public regulation. Formerly, government policy was focused on regulating a monopoly. The result of this governmental involvement, along with major technical advancement fostered by the industry, has been the provision at very reasonable user cost of a universal communications network unequaled in the world. In the past few years, however, Federal policy has made a departure from its previous regulatory practice. This action, while considered inevitable by many industry and government observers, poses a number of difficult economic problems.

The Justice Department and the Federal Communications Commission (FCC) have taken independent and bold action in the past few years to deal with structural changes. The Congress has attempted to provide the FCC a legislative direction but has failed to do so in the last several years. Following a decade of complex antitrust suits, the Justice Department and American Telephone and Telegraph (AT&T) settled their difference in 1982 by a complete restructuring of the dominant firm of the industry. Hence, the whole industry will take on a new appearance. The FCC has concentrated its efforts in reforming the interstate rate structure and promoting competition. Subscribers now can own their own phone if they desire, and are able to purchase one from a large number of suppliers at greatly reduced prices.

Over the past 40 years or more, telephone rates have been lowered significantly through technical improvements. Much of the cost-saving technology was in long distance services, and a portion of long distance profits was directed to support local service operations. This cross-subsidization practice has led to some problems in the pricing and usage of telephone service and thus thwarted an accurate market response to price and profit signals. However, a defendable case for some degree of cross subsidy exists due to the interdependence between local exchanges and long distance carriers given a single national telephone network. The long distance network relies on local exchanges for call completion, and local exchanges must be connected to the long distance network to provide communications on a nationwide basis. The case for cross subsidy has become more complex with competition in the long distance market and with potential bypass of the local exchanges. As might be expected, high cost areas are heavily reliant on cross subsidies.

The currently used pricing practice is to have interstate long distance call charges absorb about 26 percent of the fixed costs associated with local exchanges. Since these charges are usage-based, the more long distance calls you make, the more you contribute to maintaining the local exchange. Because long distance represents about 11 percent of total calls made and just 8 percent of total minutes, the FCC and others argue that long distance users should not be paying as much as they are. Artificially high long distance rates create an incentive for large volume users to bypass the public network and establish private facilities.

The FCC has decided that the cross subsidy between interstate calls and local exchanges (which in 1981 amounted to about $7 per month per phone line nationally) should be phased out. It would be replaced by a phased-in access charge on telephone users (initially up to $6 per month on business and $2 per month on residential customers). At the same time, long distance rates would be lowered. (AT&T has applied for a 10½ percent rate decrease pending the implementation of the access charge decision.)

Despite the merits of the access charge approach, the Congress is sensitive to voter outrage over telephone rate increases. The House passed, and the Senate considered, legislation which would disallow or postpone access charges on residential and one-line business customers. Curiously, the Congress did not address the $6 business access charge which will be a noticeable increase for most small businesses, and primarily is concerned only with residential users.

The FCC, fearing the disastrous consequences of Congressional action, announced a modification of the access charge order. Bowing to political pressure, it postponed residential and one-line business access charges, increased the financial support to high cost areas, and revised the access charge on long distance carriers competing with AT&T, all pending a new study which is due in December 1984.

The controversy over access charges is not settled easily, not only for the political reason that rate increases are unpopular, but also because the pricing system has other problems. Critics claim cost studies have been inadequate in providing essential information in sound decisionmaking. Changes in the industry are forcing a wholesale reevaluation of how customers will be best served in the future.

Many Federal regulators and industry analysts boast of the merits and benefits of exposing the telecommunications industry to competition. This view is disputed vigorously by others, however. Dr. Alfred Kahn, for example, in an October 1983 Joint Economic Committee hearing, questioned the wisdom of allowing competition in the long distance market. At that hearing he said, ". . . there was never the same clear case for deregulation of communications that, in my opinion, there was for airline and trucking." He went on to say, ". . . we may find 20 or 30 years from now we wished that we were back at the monopoly stage."

Because of technical changes in the telecommunications industry, traditional regulatory practices are not sustainable if consumers are to be served and public goals are to be preserved. With respect to the new regulatory direction, it is not known whether the long-distance service industry can operate optimally, or even satisfactorily, in a competitive environment. The FCC appears confident that it can. However, the characteristics of this industry do not match perfectly with the requisite conditions of a competitive market structure. Those imperfections will prevent some of the acclaimed benefits of competition from materializing fully and may indeed jeopardize the universal service concept. The following points demonstrate the problems associated with subjecting the industry to competition and subjecting customers to greater exposure to true costs:

1. Recent entrants to the long distance market—other common carriers (OCCs) such as MCI, Sprint and SBS, regional WATS resellers, etc.—may have only a slight economic advantage which allows them to offer lower rates. Rather, it is largely a regulatory advantage. The FCC and State regulators allow these new entrants to charge a rate different from AT&T, the dominant carrier. AT&T's long distance customers are re-

quired to contribute more financial support to all local exchanges. In essence, the presence of OCCs offers customers in selected locations an opportunity to take advantage of markets allowing de-averaged rates. If AT&T were allowed to compete fully and equally in those markets, the competition may not survive. Thus, the market may not be able to support many competitors.

2. A fundamental question regarding fairness can be posed about offering certain customers a price advantage. This possibly discriminatory practice allows some preferred customers to escape certain regulatory rates designed to help finance the national phone network regardless of whether they pay their own full cost of having telephone service.

3. Current prices for telephone services do not reflect the costs associated with them. It is estimated that 90 percent of all residential subscribers—urban and rural alike—do not pay the full cost of local service. If customers were to pay the full cost, the price for having a dial tone, that is access—before a single call is made or received—would be $26 per month per line on average. Both public and industry officials are concerned that if all these fixed costs were imposed on customers equally, then a sizeable portion of them may elect to discontinue service, which is not in the interests of the public policy goal of universal service.

4. Pricing according to marginal costs requires that each cost causer be his own cost payer if a perfectly competitive environment is to be maintained. If each customer were to pay specifically the true cost of having service, telephone service charges would vary widely, from about $20 per month in some densely populated urban settings to $100 and more in sparsely populated rural areas. Since this cost variance is another threat to universal service, some price averaging can be expected in the future, which will compromise the effectiveness of competition.

5. Nearly all types of telephone services use commonly shared facilities. This makes cost allocation difficult and arbitrary. Long distance calls must have access to local exchanges to complete the connection, and customers on local exchanges must have long distance interconnection to contact persons on other local exchanges. This mutually beneficial and interdependent relationship makes both services more valuable but presents a challenging pricing problem.

Correcting the current problematic pricing structure will be a difficult political challege. Any sound and practical solution would entail shifting more of the cost burden onto customers who presently are not paying all the costs they are creating. Telephone service charges would decrease for large users of long distance if toll rates were to drop in response to a drop in the existing cross-subsidy system. The cross-subsidy flow in the telephone industry is not based on geography per se. The flow is from users of overpriced long distance services to users of underpriced local service. A mistaken but commonly held view is that residents from New Jersey, for example, subsidize Nevada residents. Most New Jersey customers do not, but the large corporations located there do indeed.

Businesses making extensive use of long distance would be the beneficiaries of shifting more costs onto end-users. This shifting principally would be forwarded to residential customers who do not make a substantial number of long-distance calls. Unfortunately, if this cost adjustment is not made, residential customers may have their underpriced local service threatened by rate increases from another direction as well—private network bypass.

Technical advances have made private networks economically viable alternatives to the public network for a growing number of firms. Just 1 percent of all business customers generate 50 percent of business revenue. Telephone rates could jump dramatically to compensate for revenue shortfalls if even a few customers dropped off the network. Bypassers also are difficult to retrieve back to public network because of the large capital investment required to build private systems.

Politicians are likely to face some voter disenchantment due to price increases whether the FCC-proposed access charge goes into effect or not. The current cross-subsidy system simply is not sustainable if the industry is to be competitive and if prices and costs are to be used to allocate resources properly. If prices are not adjusted toward cost in the long-distance market, then "bypass" problems are inevitable, and billions of dollars of valuable revenue support to the public network could be lost.

Prospects are dim for a quick and satisfactory solution to the pricing problem because more is required than merely implementing an access charge. Given the present uncertain political reception to raising rates on residential customers, the public would be better served by reevaluating the entire pricing system of the telphone industry.

TRANSPORTATION

At the present time, there is no clear consensus whether transportation deregulation has resulted in a net benefit or loss to society as a whole. Economic experimentation, as this reversal in longstanding Federal policy has been called, is not given the opportunity to compare results with a "control group" as other social sciences are afforded. Although the transportation sector has had several years to adjust to a deregulated environment, conclusive documentation has not been ascertained. To a significant degree, an unstable economic climate has clouded the information gathered to date.

Predictably, opponents of deregulation are finding fault with the changes and are appealing to adverse findings without taking into account the whole economic picture. Two recessions in as many years crippled the demand for transportation services. Real incomes of consumers declined due to double-digit inflation. The transportation sector not only suffered because of a rise in overall prices, it also was hit hard by huge increases in fuel costs. High interest rates, too, had a significant impact on this sector during the initial years of deregulation. As barriers to entry were lowered, a large number of firms emerged. Many were undercapitalized and could not absorb high financing costs. Consequently, they did not survive. While deregulation was responsible for attracting entrepreneurs and capitalists into this sector, it cannot be blamed for their failure.

Two clear results of transportation deregulation were changes in labor compensation and operating procedures. Under the protection of regulated rates, wage and salary increases could be factored into the pricing schedules with little justification. Price competition halted automatic compensation adjustments. The management of large, established firms, typically employing union labor, was required to look closer at labor productivity as well because smaller startup firms usually were paying lower wages to nonunion labor. Operating procedures have undergone an overhaul in all transportation modes since deregulation. Major airlines, for example, have adopted hub-and-spoke route systems which utilize airplane capacity better while minimizing variable costs. In addition, some newer airlines have implemented new ticketing procedures and passenger services and have given pilots adminstrative duties to streamline labor costs.

Besides making individual transportation modes more cost conscious and efficient, another benefit of deregulation has been to make the entire transportation network more effective by allowing market forces and technical advantages to prevail. Railroads are thriving along long haul routes. Trucks are utilized where they offer the best advantage, typically shorter hauls or ones requiring flexible destinations or timetables.

Surface transportation was exposed to a new set of rules with the 1980 adoption of the Staggers Rail Act and the Motor Carrier Act. The intended result was to facilitate coordination and competition in and between these two modes. Some analysts argue that the trucking industry has been put at a disadvantage, however. The issues of market dominance, revenue requirements, and protecting captive shippers will require greater attention by the Interstate Commerce Commission in the new regulatory environment. The cost structure also requires special attention since cost-based pricing is a characteristic of competition. In addition, an overlap of the two modes is present with the use of "piggyback" (trailer on flat car) services, which requires oversight.

In an improved and more stable macroeconomic setting, the industry will be more able to adjust to the changes begun some eight years ago. Since no conclusive evidence can resolve whether deregulation has been successful thus far, perhaps the appropriate action of legislators and regulators is to seek answers to fundamental economic questions, such as the following: How has the emergence of competition and lessened regulation (1) changed the composition (size and number of firms) of the industry, (2) affected rates of return, investment risk and activity, costs and flows of capital, (3) influenced turnover (exit and entry) in the industry, (4) affected employment requirements and wage levels, and (5) resulted in better service and lower costs?

Ultimately, the deregulatory success would involve determining whether the public has benefitted by the change. Without an affirmative response, the transportation sector may be exposed to increased governmental control in the future.

CONCLUSION

Because of its pronounced effect on society, government intervention causes advocates and opponents to discuss the nature of regulation in a broad philosophical context. Regulation could be considered as a guiding system to minimize the "growing pains" associated with economic evolution. Sometimes a paternalistic role is ascribed to justify regulation, suggesting that the disadvantaged will be disregarded by an immoral public in the absence of the government's benevolent caretaking. Another personification takes on the guise of a policeman. In this analogy, order is maintained and the public is protected by an omniscient and omnipotent authority which detects, apprehends, and punishes wrongdoers. Opponents often object to regulation on the grounds that it hinders individual choice, freedom and liberty, and imposes an economic burden on society. Adam Smith's classic reference to the "invisible hand" reveals tremendous confidence in free individuals and free markets.

Unless governmental action can be justified on both economic and social grounds, it fails to serve the public. Too often regulation results in the impression of protection, not the accomplishment. The government does not have a monopoly on benevolence. U.S. citizens and businesses are among the most generous, charitable, and volunteering in the world. The government is not the only watchdog. American consumers demand high quality and dependable service. Many manufacturing and service industries engage in peer reviews using standards which exceed legal requirements. In fact, proponents of extreme governmental intervention may be subverting the public to an eventual dependence on, and subordination to, the government. Some may relish such a political prize. Clearly, self reliance—a major ingredient contributing to America's success—is too important to sacrifice for the alleged benefit of an increased role of government in society.

Nevertheless, the economic, geographic, and demographic diversity of the United States presents an obstacle for standardized regulatory reform. There simply are too many exceptions to any general rule. Urban citizens face economic and social circumstances which are different from those confronting rural and small town residents. The same can be said about large and small businesses, centrally coordinated franchises and individual proprietorships, high-tech and traditional "smokestack" industries, capital-intensive and labor intensive industries, high-income and low-income households, wealthy and poor people, educated and non-educated persons, and skilled and unskilled workers.

The Federal Government should review its implementation of regulatory reforms instituted to date. By doing so, a "midcourse correction," if needed, may serve the interests of society better than substantial regulatory correction in subsequent years. Indeed, proponents of further deregulation actually may be in a better position to preserve their cause by substantiating it with positive evidence. This is not meant to imply that now is the time to re-regulate. Rather, now may be the appropriate time for regulatory evaluation.

Economists recognize that any divergence from competitive market forces through governmental intervention will result in less consumer satisfaction and less economic efficiency. The world certainly is not perfect and, hence, regulation as a necessary check and balance is a compelling argument. Consumers would be better off if regulatory actions were justified by economic criteria. Generally, this goal could be accomplished if social and economic benefits exceed social and economic costs. Moreover, overall economic well being could be maximized or costs could be minimized if incremental benefits were equated with incremental costs. The distributional problems associated with regulation, or the phase-out or absence of it, must be resolved fairly and equitably.

Oftentimes, regulation is promoted to protect the disadvantaged in our economic and social system. As a result, public regulation constrains the efficient, while perpetuating the inefficient. Often regulatory practices by design avoid addressing the causes of inefficiency in the economy.

A publication by Lipset and Schneider interpreted a Harris poll in the following way:

> Respondents who thought there was too much regulation of business commented most frequently that regulation favors big business over small business, protects monopolies, controls or limits competition, interferes with production and free enterprise, allows for price-fixing, and creates too much red tape. In other words, those who say that there is too much regulation defend their position by expressing the same values and priorities as those who say there is not enough regulation! Regulation is both advocated and criticized in the name of free enterprise and a competitive economy.

This paradoxical statement demonstrates the necessity of some degree of governmental oversight in our society. So long as regulators are conscious of the costs they impose on consumers and taxpayers and seek efficient and effective rules, and so long as business complies with fair rules and is allowed to appeal unfair rules with appropriate responsiveness on the part of government, society will be well-served.

VII. AGRICULTURE

The food and agricultural system of the United States accounts for over 22 percent of U.S. employment and over 20 percent of this country's gross national product. The efforts of approximately 3.4 million people directly employed in farming—production agriculture—creates an additional 20 million jobs: 1.7 million in food processing, 2.5 million in resource supplies, 5.0 million in manufacturing, 7.6 million in transportation, wholesaling and retailing, and 3.3 million in eating establishments. Assets devoted to agriculture amount to nearly $1 trillion. That figure is equal to almost 90 percent of the combined total assets of all manufacturing firms in the United States. The value of farm assets, coupled with the economic activity generated by farm products flowing through our economic system, makes agriculture and the food and fiber system this Nation's largest industry and employer.

The food and fiber sector produced about $529 billion worth of goods in 1982, consisting of $298 billion in consumer purchases of domestically produced food, $37 billion of agricultural exports, $118 billion of clothes and shoes, and $24 billion of tobacco. The initial sale of $84 billion of raw agricultural commodities yielded $529 billion worth of goods for the U.S. economy. More than $6 are generated for every dollar created by production agriculture.

Farmers also are substantial purchasers of goods and services. Farmers purchased $105 billion of inputs in 1982, $74 billion of which were of nonfarm origin.

Because of farming's extreme productivity in the use of inputs, substantial amounts of resources—land, labor, and capital—are freed to be employed in the production of other goods and services. Farm productivity increased 12 percent in 1981.

United States consumer expenditures for all food, including imported food, amounted to about $400 billion in 1982, or 15.4 percent or personal income. Compared to previous years, this represented a reduced share. The share was 16.2 percent 10 years ago, and 19.1 percent 20 years ago, indicating that the relative burden of food on the family budget is lessening. While even 15.4 percent may seem large, it is much less than the share of personal income accounted for by food in the United Kingdom, France, Japan, and virtually all other developed countries. In addition, the quality, nutritional value, and variety of food available to U.S. consumers is unmatched anywhere else in the world. The tremendous growth in productivity of the U.S. agricultural system freed billions of dollars of consumer income for the purchase of other goods, savings, and investment. If Americans had devoted 20 percent of personal income to food purchases in 1982, $116 billion more would have been spent on food and, therefore, not on the products and services supplied by other industries.

Food prices have contributed significantly to recent dramatic declines in the rate of inflation. The limited increase of 2 percent in prices received by farmers for farm foods in 1983 kept the increase in prices paid by consumers for food (consumed at home and away-from-home) down to 2.2 percent, the fourth consecutive year of slowing retail food price rises.

In response to increased world demand for U.S. farm commodities, expanded agricultural exports have had an enormous impact on the U.S. economy. Farm commodity exports represent about one-third of total U.S. cropland production, indicating farmers' high dependence on foreign markets. After two years of decline, the value of U.S. farm exports is expected to rise to $39 billion in the 1983–1984 crop year, up 12 percent from the $34.8 billion in the 1982–1983 crop year. Agricultural imports are expected to increase only moderately to $17 billion, allowing the agricultural trade surplus to climb to $22 billion, up $3.6 billion from the 1982–1983 crop year. In recent years, agricultural exports have covered over one-half the cost of imported petroleum and petroleum products. In addition, the Department of Agriculture estimates that a $1 million export sale of wheat, for example, generates almost $5.5 million of direct, indirect, and induced business activity in the U.S. economy.

Being the world's leading agricultural nation has provided the United States with powerful political, as well as economic, leverage in international relations. In addition to $39 billion of commercial sales, U.S. farmers, through their government, contribute greatly to world food security—the assurance of regular and adequate food supplies for a significant portion of the world's population. The United States is the largest donor of food aid in the world, which is achieved in part through its P.L. 480 donor program and by being the largest contributor to the United Nations World Food Program and the International Emergency Food Reserve. In addition, U.S. participation in export credits, the International Monetary Fund, and the World Bank helps to facilitate financial arrangements to promote food consumption and distribution.

The United States further enhances world food security by maintaining, at its own expense, adequate national and global stocks to meet inherent year-to-year fluctuations in grain production. The United States, in fact, is the only nation with an intentional policy of holding carry-over grain reserves in order to meet international and domestic needs. In addition, the United States has comprehensive programs designed to assist developing countries in increasing their domestic food production. The actual and potential manipulation of commercial agricultural sales by the Federal Government to pursue foreign policy objectives, while certainly controversial, is nonetheless another attribute and contribution of U.S. agriculture.

National and International Economic Influences

Perhaps the most fundamentally significant difference between the agricultural industry of 20 years ago and the industry today is the tremendous influence of national and international economic forces outside the farm sector on the U.S. food economy. Though historically isolated and insulated from changes outside the farm sector, agriculture has been integrated into the macroeconomic system.

A number of negative influences were imposed on the farm sector during the latter 1970's, including inflation, high interest rates, sagging commodity prices, and a faltering domestic economy whose real output and income stagnated and actually declined. On the international level, American agriculture was affected by fluctuating demand, a global economic slowdown, and peculiarities in foreign currency exchange rates. Each of these factors has had a dramatic effect on farm income and financial well-being.

Today's depressed farm economy is readily and directly traceable to the economic policies of the late 1970's which yielded high inflation and high interest rate levels.

Between 1977 and 1980, farm production costs increased 45 percent, from $89 billion to $129 billion. Those years of high inflation devastated farm net income and thereby the farm economy. Ten years ago, farm cash sales totaled $87 billion and production expenses were $65 billion, yielding a net income from farm sales of $22 billion. Back in 1973, it took less than $4 of product sales to generate $1 of net income. But, while farm cash receipts have increased 66 percent since 1973, production costs skyrocketed 117 percent. As a result, today a farmer needs to sell over $32 of product to realize $1 of net income. Had those inflation rates of 12 percent in 1978, 19 percent in 1979, and 9 percent in 1980 been kept down to just 8 percent each year, farm net income from sales would have been $22.5 billion in 1982, rather than $4.5 billion. Those three inflationary years have cost farmers over $70 billion of net income during the last five years.

In addition, when the previous Administration took "control" of this country's economic policies in 1977, the interest rate on nonreal estate farm loans was 8.8 percent. Four years later, this interest rate stood at 17.9. The prime interest rate went from 6.25 percent to 21.5 percent. The prime is currently at 11 percent.

This doubling of interest rates more than doubled farmers' interest rate payments from $7 billion in 1976 to $16 billion in 1980. On January 1, 1977, total farm debt stood at $103 billion. Four years later, on January 1, 1980, total farm debt had climbed 70 percent to $175 billion. Tragically, this phenomenal addition to debt incurred by farmers during the late 1970's will burden generations of farmers to come.

Add the grain embargo of January 1980 and one begins to understand the roots of the farmers' current financial plight.

Commensurate with these record cost increases came record crop production levels, a global recession, and the build-up of price depressing carry-over stocks. The Reagan Administration implemented a $30 billion supply control effort, including the payment-in-kind program, and created and expanded its export-blended credit program to reduce stocks and improve farm prices and incomes. Aided and abetted by the drought, carry-over stocks of corn were reduced from 3.14 billion bushels in the 1982–1983 crop year to 595 million bushels in the 1983–1984 crop year; soybean stocks from 387 million bushels to 185 million bushels; wheat from 1.54 billion bushels to 1.44 billion bushels, and cotton from 7.9 million bales to 3.6 million bales. While highly volatile, most commodity prices in late January 1984 are substantially higher than year-ago levels: soybean prices are up 30 percent, corn prices 30 percent, and cotton prices 20 percent. Wheat prices are near last year's levels. These percentage increases, however, are modest relative to the price levels achieved by many of these commodities in the early fall of 1983. The "bullish" effect of low-ending stocks has been more than offset by price-depressing influences such as the high value of the U.S. dollar, expectations of large crops in 1984, a continuing depressed livestock sector, large remaining stocks of wheat, a sluggish global economic recovery, and other factors.

Policy Considerations

The evidence, of course, is stacked heavily against anyone who desires to state categorically that traditional commodity programs have failed agriculture. Walter Wilcox reported in 1958 that net farm income for the period 1952 to 1956 would have been at least 28 percent lower without price support programs. Simultaneous but independent studies by others yielded remarkably similar results. These studies reveal that had production restrictions and price supports been eliminated, net farm income would have declined anywhere from 25 to 40 percent. Other research has found that commodity price support programs reduced price variability for selected crops. These are only examples from a large volume of research efforts almost unanimously extolling the effectiveness of commodity programs during the late 1950's and early 1960's. With the consumer price index for food advancing little more than 1 percent per year from the mid-1950's to the mid-1960's, the impact of commodity programs on consumer prices was of little concern or interest.

Two key developments, both beginning in the mid-1970's have eventually caused many farm policy analysts to conclude, as Dr. G. Edward Schuh of the University of Minnesota has, that commodity programs have become "demonstrably counterproductive."

The first development was the extreme and rapid internationalization of U.S. agriculture. During the 25-year period, from 1947 to 1971, the value of U.S. agricultural exports rose moderately from $4 billion to $7.7 billion. In contrast, during the next 10-year period, 1971 to 1981, the value of U.S. agricultural exports increased almost six-fold. Exports sales now account for one-half of crop cash marketings as opposed to 20 percent in 1950. During this same period, production agriculture assets grew from $135 billion to over $1 trillion. Traditional commodity programs are incapable of providing a "fair return to farmers" given the size of their industry and with the majority of crop-farmer income coming from nondomestic sources. The job simply has gotten too big and too unmanageable.

The second development was the diminishing influence of the value of farm goods relative to consumer food costs. A central objective of commodity programs is to assure reasonable food prices. But farm value as a percentage of food expenditures has declined from 33 percent to 28 percent since 1972. During the last two years, labor costs have exceeded farm value as a percentage of total food expenditures. As a result, it may make more sense to put the burden and responsibility on labor for moderating food prices than on the farmer. During the last 3 years, while record food surpluses were being accumulated and the farm value of food increased but 6.5 percent, total food expenditures increased almost 25 percent.

These developments give evidence that the two objectives most often attributed to commodity programs—to yield a fair return to farmers and reasonable prices to consumers—are unachievable in today's agricultural and food environment. Congressional and Administration leaders must develop and implement the next generation of farm policy.

During the so-called banner years of U.S. agriculture—the decade of the 1970's—almost one-half of all farmers lost money, year in and year out. In fact, in 1973, the best farm net income year on record, 39 percent of all U.S. farms showed a loss. According to an Internal Revenue Service analysis of farm income tax returns in 1976, over one-half of those returns showed financial losses from farming. As a result, the average farm income per farm in 1976 was a dismal $1,268. However, when off-farm income is added to the picture, average adjusted gross income per farm in 1976 was $14,500 and the adjusted gross income for all farms reporting losses was $13,600.

There were 12,000 farm tax returns that showed farm operation losses of $50,000 or more. These same returns showed an average off-farm income of $122,000—the larger the off-farm income, the larger the farm losses. The average adjusted gross income of all farms with losses exceeded the adjusted gross income of 75 percent of all farms reporting profits in 1976.

In another study, Dr. Luther Tweeten of Oklahoma State University has shown that in 1981—a year of depression-level real net farm income—almost 70 percent of all agricultural output was produced under profitable conditions. Dr. Tweeten's data reveals that farms with gross sales of over $100,000 required a parity ratio of 59 to cover all costs in 1981, when the parity ratio was actually 61. During that year, 87 percent of all output would have been produced at a profit at a parity ratio of something less than 64.

The farm problem appears not to be the profitability of farming, but the profitability of farms. Agriculture's profitable output in 1981 was produced by only 12 percent of the farms. However, on average, small-scale farms with sales of less than $10,000 had a combined on- and off-farm income of over $20,000 in 1981, which was near the national household income average. These small-scale farms account for almost one-half of all farms.

The above seems to suggest that food production in this country is not in financial jeopardy. Twelve percent of all farms are profitable. In addition, while half of all farms show negative returns from their farming operations, they are sustained through substantial off-farm income. It may be concluded that six out of 10 farms—approximately 1.5 million—are not largely dependent on public assistance for income support. Said another way, four out of ten farmers may need and deserve greater assistance than is provided through the current Federal farm programs. A critical ingredient to the solution of the farm problem is to decide what kind and degree of public support is needed to assist these 900,000 or so farm families who find themselves in agriculture's transition zone—either reluctant or unable to generate sufficient off-farm income or lacking the financial resources to achieve a profitable-sized farm unit.

These farm families who are experiencing the financial, professional, and social pressures of transition are most likely the core of the farm problem. Furthermore, the volume-progressive government payment structure of traditional commodity programs is worse than useless to medium-sized farms. These farmers will suffer greatly if the public's current disenchantment with farm programs results in less Federal assistance. Large successful farms merely will be denied the return to which they are entitled.

A critical point must be made at this juncture—an observation which may suggest a possible approach to remedy the farm problem as described above. The success of U.S. production agriculture can be credited largely to the family structure of farming. Few labor-management units have proven more innovative, productive, and resilient.

Improvements in farm income can come only from one of two sources: the market or the Federal treasury. Higher public costs for farm programs likely is not a realistic option; but then neither is a free or wholly market-oriented U.S. agriculture.

Given agriculture's inherent characteristics—production time lags, perishability, and inelastic domestic demands—the market will never yield fully compensatory prices for all U.S. farmers. But, according to studies, it can and has produced prices which are profitable for most of the volume of commodities grown in this country. However, these prices also are unprofitable for a vast majority of farmers. That is, U.S. production agriculture can compete in export markets but it naturally will "sell" to the highest bidder. The U.S. Government itself becomes the high bidder through its loan program. As a result, some farmers receive a windfall, others break even, but the vast majority will continue to suffer losses. In addition, and perhaps equally important, other world food producers and their governments escape the full competitive clout of American agriculture.

Certainly an undesirable consequence of current farm programs has been to protect foreign food producers, who are less efficient, from full competition with efficient U.S. food producers, at tremendous cost to U.S. taxpayers. The continuation of farm programs which reduce the U.S. share of world food production, while at the same time builds price-depressing government-held surpluses, may be the road to U.S. agricultural oblivion, and thereby future generations of farmers are jeopardized. The domestic and global economic, social and political consequences of an America without agriculture are beyond comprehension. Since 1981–1982, while the United States reduced its grain production by 124 million metric tons, the rest of the world increased its production by 95 million metric tons. Our market share of world grain and soybean exports has declined from 52.2 percent in the 1981–1982 crop year to a projected 47.5 percent in 1983–1984.

United States farm policies must be both long-term and global in perspective and recognize and appreciate U.S. agriculture as a world resource. Survival of the most efficient is a fundamental principle of our economic system and this principle should be pursued in the world agricultural economy. The combination of our natural resource base, technology, highly innovative farm families, and management and distribution system make U.S. agriculture the most efficient, responsive, and productive in the world. From an economic, political, or humanitarian perspective, U.S. farm resources should be the last to be retired.

Federal price and income maintenance commodity programs are heavily export, crop, and output-oriented. In fact, government payments apply to only 35 to 40 percent of the value of annual farm marketings—the sale of grains, cotton, and dairy products ($53.3 billion out of a total of $143.5 billion of farm marketing in 1981). In addition, hundreds of thousands of family farms that produce specialty commodities largely for domestic consumption are financially distressed. Yet they receive little public attention, let alone assistance. There may be substantial economic and social benefits of a "smaller-farm farm policy" which is more farmer oriented and less volume and commodity-biased.

The next generation of farm policy may better serve America and its farmers by unleashing U.S. agriculture's present competitiveness and future potential, targeting public support, preserving its natural resource base and family structure, and confidently and aggressively pursuing new opportunities.

ADDITIONAL VIEWS

ADDITIONAL VIEWS OF SENATOR STEVEN D. SYMMS

In my opinion, there are a variety of forces in the economy and financial system which are combining to produce a very delicate situation that can only be addressed by significantly reducing the current level of debt in every sector of the economy—the personal level, the business/corporate level, State and Federal Government level, and the international level.

The present strategy, which combines higher levels of government spending with large deficits, a firm monetary policy, high real interest rates, and large current account deficits have worked to produce a non-inflationary period of growth in the economy, *for the short-term.*

The short-term success of the present strategy can be traced to the discipline that was imposed on the system by tight monetary policy. Tight money provided temporary relief from inflation. However, when combined with an opposing fiscal policy there was a tremendous cost—private sector bankruptcies and unemployment.

The combination of large spending increases and relatively monetary policy has put upward pressure on real interest rates and has attracted foreign capital to our economy, temporarily compensating for our own savings deficiency and at the same time financing a considerable portion of our deficit.

The simple fact is that fifty years of accumulated debt is coming due and we are faced with the enormous problems resulting from a fifty-year effort to spend ourselves into prosperity. The full impact of that debt will be felt when foreign investment flows outside the U.S. economy, thus reducing funds available to finance the exponentially increasing deficits.

Consequently, it is our responsibility to implement a long-term solution to our problems. We have only three choices at this time: Reduce government spending and, therefore, decrease the government's involvement in the credit markets, maintain the current spending levels and, therefore, further squeeze the private sector's ability to grow, or significantly increase the money supply in order to monetize existing debt, resulting in an increase in inflation and interest rates.

Obviously, the only long-term resolution to our economic dilemma is to reduce Federal expenditures in those years of the budget which have grown uncontrollably in recent years. While savings can be achieved in the defense budget, simply reducing defense expenditures will not address this issue. There are those that will make the argument that a strong economy is more important than a strong defense and that a strong defense is not possible without a strong economy. However, historically, the corollary has also been true—it is impossible to maintain a strong economy without a strong defense.

In recent years, Congress has attempted to reduce the size of the Federal deficit by cutting defense spending and increasing taxes. During the 1970–1980 period, the budgets for income transfer programs increased 350 percent, while defense expenditures increased only 150 percent.

Unless Congress addresses the problem of transfer payment and entitlement programs, we will never balance the budget, or have a sustained, long-term recovery. Even if defense spending were to be cut substantially this year, we would still be faced with exactly the same situation next year. The entitlement spending would continue to grow, and still further cuts would be required in defense the following year. This would be a never-ending process until we reached the point where there was nothing left in the Department of Defense to cut—the end being a defenseless welfare state.

Furthermore, attempting to reduce the size of the budget by increasing taxes is not reasonable since it is not possible to increase productivity while strangling the economy with high tax rates. If the trend that has been set in recent years continues, the market reaction will be "business as usual—Congress does not have the leadership or the fortitude to make the necessary budget reductions." As a result, I am certain that the market's inflationary expectations will remain, and most likely worsen.

Our future economic course, if present trends continue, will yield an inflationary depression. If the Congress does not reduce the uncontrolled spending in the Budget, the pressure on the economy will come through the currency. Historically, most nations have failed to pay their debts. They have instead chosen to monetize their debts, thereby passing the wealth of the private sector to the public sector. If we do not have the fortitude to implement major spending reductions in the Federal budget, I believe our own Nation will follow the unfortunate historical path of our predecessors.

ADDITIONAL VIEWS OF SENATOR STEVEN D. SYMMS AND REPRESENTATIVE DANIEL E. LUNGREN

We must dissent from that portion of the Annual Report which calls for establishing a Deficit Reduction Commission. In our view, such a commission would be no more than an acknowledgement of the Federal Government's failure to address the deficit dilemma confronting our Nation and an inappropriate substitute for the required Congressional action.

Commissions are typically recommended when Congress does not have the will to act. This, we believe, would be especially true of any commission formed to reduce the deficit. Instead of creating a political heat shield for Congress, our legislative institutions and their members should be forced more firmly into the glare of the public spotlight on this issue. The facts are clear! Deficit spending has become an accepted norm in the running of our government. Furthermore, as a consequence of continued deficit spending, 12.5 percent of the budget, or the fourth largest government expenditure, is now devoted just to pay interest charges on the national debt. The New York Times recently reported that the $110 billion savings enacted by Congress from 1982 through 1985, was less than the $124 billion increase in spending to pay the interest on the Federal debt.

The lack of Congressional action to reduce the deficit, not just this year but over the past several decades, reminds us of a quote attributable to Lon Holtz: "When all is said and done, a lot more is said than done." Unfortunately, this inaction has become characteristic of recent Congresses rather than an infrequent occurance.

Under our Constitutional system and current budget process it is Congress which has primary power over the fiscal purse. While it is true that the President may recommend spending and revenue levels, he cannot take any specific budget action until Congress has sent him an appropriation bill.

Even when the Constitution affords the President a participatory role in deciding to sign or veto appropriation measures, Congress has an incredible advantage over the President in enacting spending bills. The legislative branch knows that the executive is forced into an all or nothing situation in deciding whether to veto or sign an entire appropriation bill. Consequently, the President is frequently reluctant to halt government funding of necessary programs despite the fact that if he had the power he would delete the funding for several less essential programs which are typically included in spending bills.

The ability of the President of the United States to enact budgetary discipline pales in light of the fiscal tools available to the executive departments in 43 of our States, which are permitted authority to line-item veto budget bills. Illustrative of the power of the line-item veto is the recent experience of California Governor

Deukmejian. During the last fiscal year, the Governor used the line-item veto more than 350 times to cut $1.7 billion from the amount which the State legislature has passed. Needless to say, without the line-item veto authority the budget for California would not have balanced.

However, it would be shortsighted to assume that the total significance of the line-item veto lies in the ability of the President to delete funding for certain selected programs. Just as the President would know that his veto would be subject to a two-thirds override in both Chambers of Congress, so, too, would the Congress be cognizant of the President's ability to exercise his veto. The result of providing the executive the authority to use the line item veto would be enhanced accountability in budgeting. Each budget item would have to be enacted on the basis of its own merits and its possible subjection to a two-thirds vote standard rather than by slipping into an omnibus spending package at some late hour of Congressional deliberation.

Milton Friedman is right, "the key objection to deficits is political, not economic." We in Congress are familiar with the economic arguments against continued deficit spending. Yet, despite the economic rationale, year after year Congress continues to rack up deficit after deficit. In putting his finger on the problem, Dr. Friedman has gone so far as to state that electing the right people in government will not eliminate deficits, because that has been tried to no avail. According to him, attempts to create a more effective congressional budget process has also failed. Dr. Friedman summarizes, "A Constitutional amendment is needed to enforce political responsibility."

But while many in Washington may have become accustomed to deficit spending, the people of this country will simply not tolerate their government to continue spending more than it takes in. The cold reality which Congress will have to face up to is that currently 32 out of a required 34 States have called for a Federal convention to consider a constitutional amendment to balance the budget. Grassroots efforts in several key States suggest that the time is near when one or two more States may soon join the call for a Constitutional Convention. Clearly, Congress cannot ignore for long this appeal from the people.

Perhaps one of the most convincing reasons a commission is not needed is the comprehensive work of the Private Sector Survey on Cost Control. Commonly known as the Grace Commission for its energetic Chairman, J. Peter Grace, the panel recently recommended 2,478 ways in with the Federal deficit can be reduced by $424 billion in three years. Certainly, Congress may not wish to enact every recommendation, but it would be remiss to establish a new Deficit Reduction Commission without having thoroughly considered the work of the Grace Commission.

The 2,478 recommendations of the Grace Commission represent a final report embodying some 23,000 pages, the work of 36 task forces including an executive committee of 161 top executives in our country, and 18 arduous months of meetings and hearings. Not only would a subsequent commission now be redundant in the light of the Grace Commission, but the $75 million cost for the Grace Commission study—all financed by corporations, in addition to some $3.5 million donated from the private sector to pay for administrative expenses—would be for naught. Certainly after this encyclopedic undertaking, it would represent the ultimate acknowledgement of Congressional inability to reduce deficits if Congress were to now create a new commission.

The merits of creating a commission are further questioned in light of the fact that the President's bipartisan deficit reduction plan to secure a $100 billion downpayment over the next three years has been met with noted skepticism by Congressional leaders. It was recently reported that the Chairman of the Ways and Means Committee commented, "All that work is going to be done in the Ways and Means Committee." He was joined by the House Appropriations Chairman who said, "What they do doesn't limit us." This type of attitude is all too reminiscent of promises that were made during the debate of the enactment of the so-called Tax Equity and Fiscal Responsibility Act of 1982. At that time an agreement had been reached between the President and Congressional leaders that for every dollar of tax increases, three dollars of spending reductions would be made. The $98 billion tax package become law more than a year and a half ago and we are still waiting for the promised spending reductions to occur.

While there certainly are justified instances where commissions should be created, government commissions should be the exception and not the rule. A commission to reduce the Federal deficit, in our view, would be a grave mistake. There is no need to form a commision to tell us who has the responsibility to balance the Federal budget and such a commission is certainly no substitute for concrete deficit reduction efforts.

Instead of setting up another government commission, Congress should take specific action to create an environment of fiscal accountability in Washington. This can best be accomplished, as the Republican Views recommend, by sending two Constitutional Amendments to the States for their ratification: an amendment to balance the budget and limit spending and an amendment to provide the President with line-item veto authority. Additionally, Congress should pass legislative proposals to reduce the level of government spending and encourage greater taxpayer compliance.

ADDITIONAL VIEWS OF REPRESENTATIVE OLYMPIA J. SNOWE

The Republican Views on the Economic Report of the President are sound, and I am in general agreement with the conclusions reached. I believe the views correctly and realisitically highlight the outlook for continued economic recovery, while cautioning on the impact of growing Federal deficits.

As with many other Members of Congress, I remain seriously concerned with the prospect of dangerously high Federal deficits. Recently, the Congressional Budget Office released its own analysis of the President's fiscal year 1985 Budget and indicated that deficits are projected to widen over the next four years, instead of narrowing, as the Administration predicts. Regardless of the exact dollar amount, we have a problem of serious proportions that, if unchecked, will place a tremendous burden on future generations.

I am therefore encouraged that negotiations are proceeding between Congress and the White House on the $100 billion deficit reduction down payment, and that the Senate Finance and House Ways and Means Committees are pursuing their own measures. I also concur with the Republican Views that a formal commission is warranted if political pressures forestall concrete action during this election year. As the Republican Views acknowledge, all areas of the budget—including defense spending, entitlements and other domestic spending—as well as our tax system must be subject to scrutiny if both parties are to approach this problem in good faith.

Despite the anxiety over continuing deficits, the American public has good reason to be pleased with drastically reduced rates of inflation and lowered interest rates. Other economic indicators, including housing starts, personal income, retail sales and capacity utilization, have been climbing and show evidence of a prolonged recovery. The civilian unemployment rate has dropped dramatically from 10.8 percent in December 1982 to 8 percent in January 1984, but still remains too high and disproportionately affects Black and Hispanic Americans and teenagers.

The 1983 Annual Report of the Joint Economic Committee paid particular attention to employment policy and highlighted the special employment needs of women, including the necessity for strong efforts to address wage and job discrimination against women. Although significant improvement in the overall employment picture in this country has been made, I believe the unique problems faced by women in the labor market remain, for the most part, unaddressed. This has been a special concern of mine during my tenure on the Committee, and is being examined through hearings I am chairing during this Congress.

The last three decades have signaled rapid change in women's labor market patterns. The two most striking features about women's labor force participation during this time have been the rapid increase in the number of women working outside the home, and the increased participation among married women, particularly women with young children. A few statistics illustrate this dramatic change: in 1950, women accounted for less than 30 percent of the labor force; by 1982, they accounted for 43 percent. This amounted to a 148 percent increase during a period where men's labor force participation increased by 41 percent. Nowhere has the increase been more marked than among women with young children. In 1950, only 12 percent of married women with young children were in the labor force; by 1980, that figure had risen to 65 percent.

In 1983 the Census Bureau reported on the status of American women in a special report, *American Women: Three Decades of Change*. Its findings and their economic implications were the subject of a Joint Economic Committee hearing I chaired in November 1983. The report documented the disturbing patterns that affect women's economic status and their full integration into the work force. Of primary concern to me is that the earnings gap between men and women actually widened from 65 percent in 1955 to 59 percent in 1980. In the past year, there has been a slight improvement in this differential.

The report also documented that women are still pursing traditionally female fields and are proportionately overrepresented in clerical and service positions. The impact of this pervasive occupation segregation and wage discrimination can be seen in this country's poverty statistics. Approximately 60 percent of the black poverty population and a quarter of the white poverty population lived in female-headed families in 1980.

Despite landmark legislation in 1963 making it illegal to discriminate against women by paying them a lower wage than men for doing equal work, the earings gap has continued to widen. In my view, the crux of the problem is this: the guarantee of equal pay for equal work falls short because, by and large, women do not work in the same jobs as men. The Department of Labor recognizes 247 job classifications in their "Dictionary of Occupational Titles"; 80 percent of all working women in this country are concentrated into just 25 of these classifications.

The National Academy of Sciences summarized the problem in starkly realistic terms in its 1981 report to the equal Employment Opportunity Commission:

"The more an occupation is dominated by women, the less it pays." In fact, according to the report, it pays about $42 dollars a year less for each percentage increase in the number of women doing the job.

Pay equity has been recognized as the civil rights issue of the eighties. Both the courts and many States are moving rapidly to address the undervaluing of jobs performed mainly by women. Fifteen States are in the process of conducting job evaluation studies to identify the extent of wage depression in female-dominated jobs.

This year, I will be continuing my series of Joint Economic Committee hearings on women in the labor market. The first will deal with the special employment problems faced by women, including training and education, child care and welfare employment policies; the second will focus specifically on the problems of occupational segregation and pay equity; and the final hearing will look at retirement and employment problems among older women.

American women will not secure true economic equity until they are guaranteed a fair wage for the work they do. Freedom from discrimination in employment opportunity and compensation for women will be the challenge of the 1980's. I am optimistic that the Joint Economic Committe will continue to view this as a priority concern in its ongoing examination of economic policy.

DEMOCRATIC VIEWS ON THE FEBRUARY 1984 ECONOMIC REPORT OF THE PRESIDENT

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I. THE RECOVERY IN TROUBLE

The present recovery cannot be sustained without prompt action to save it. We face today the highest deficits in history and the highest real interest rates in history for this phase of the business cycle. Together they darken the economic outlook. And the Reagan Administration has no plan to set things right.

In this Report, we propose a program for immediate action to sustain growth and move toward full employment. Our program will reduce deficits and interest rates. It is an integreated, four-part plan. It is prudent. It is fair. It is realistic. It deserves bipartisan support.

This is a demand-side recovery from a monetarist recession. Declines in real interest rates fueled its initial stages, causing rapid recovery of housing and automobiles, but these will not contribute greatly to expansion in 1984. The consumer and military sectors are the mainstays now. Net export performance has been very bad. Savings behavior has been worse. The tax cuts of 1981 have failed in their stated objective: to stimulate personal savings and investment. And the Administration has neglected the foundations of long-term innovation, competitiveness, and productivity growth: education, support for basic scientific research, and the construction and maintenance of the public facilities which undergird our commerce.

By maintaining a high dollar and creating unemployment, and aided by slack in major commodity markets such as food and oil, these policies temporarily have depressed the rate of inflation. But, over the medium term, they are inflationary. If they continue, they will lead to failing productivity growth, rising prices, and pressures for a new recession long before real wage and living standards have been restored to their potential, or the unemployed have found jobs, or the needy have been lifted from distress. A new recession would threaten political and financial stability around the world.

Unfairness remains a hallmark of Reagan's economic policy. Middle-income earners have seen payroll taxes go up as overall income taxes came down. The tax reductions of 1981 provided no increased income to a household whose income averaged $32,000 or less, when adjusted for payroll taxes and inflation. Yet, those earning over $200,000 received an average tax cut of $40,000. Partly as a result, the share in all income of the richest 5 percent of families has risen steadily since 1980.

The Reagan spending cuts have fallen mainly on the poor and the working poor. Still, most of these have not yet received any significant benefit from economic recovery, and the poverty rate has risen sharply in each year of the Reagan Administration. High real interest rates boost the real incomes of those with money to lend, at the expense of those obliged to borrow. In all, the policies of the past few years are dividing American society, widening the gap between rich and poor, and squeezing the incomes, wealth, and security of the middle.

ROSY SCENARIOS

The President has written:

> As I look ahead, I am very optimistic about the prospects for the American economy. Substantial progress has been made in reforming the economic policies that will shape our economic future. If we continue to develop and pursue sound policies, our Nation can achieve a long period of strong economic growth with low inflation, and the American people can enjoy unprecedented prosperity and economic security. (1984 Economic Report of the President, p. 9)

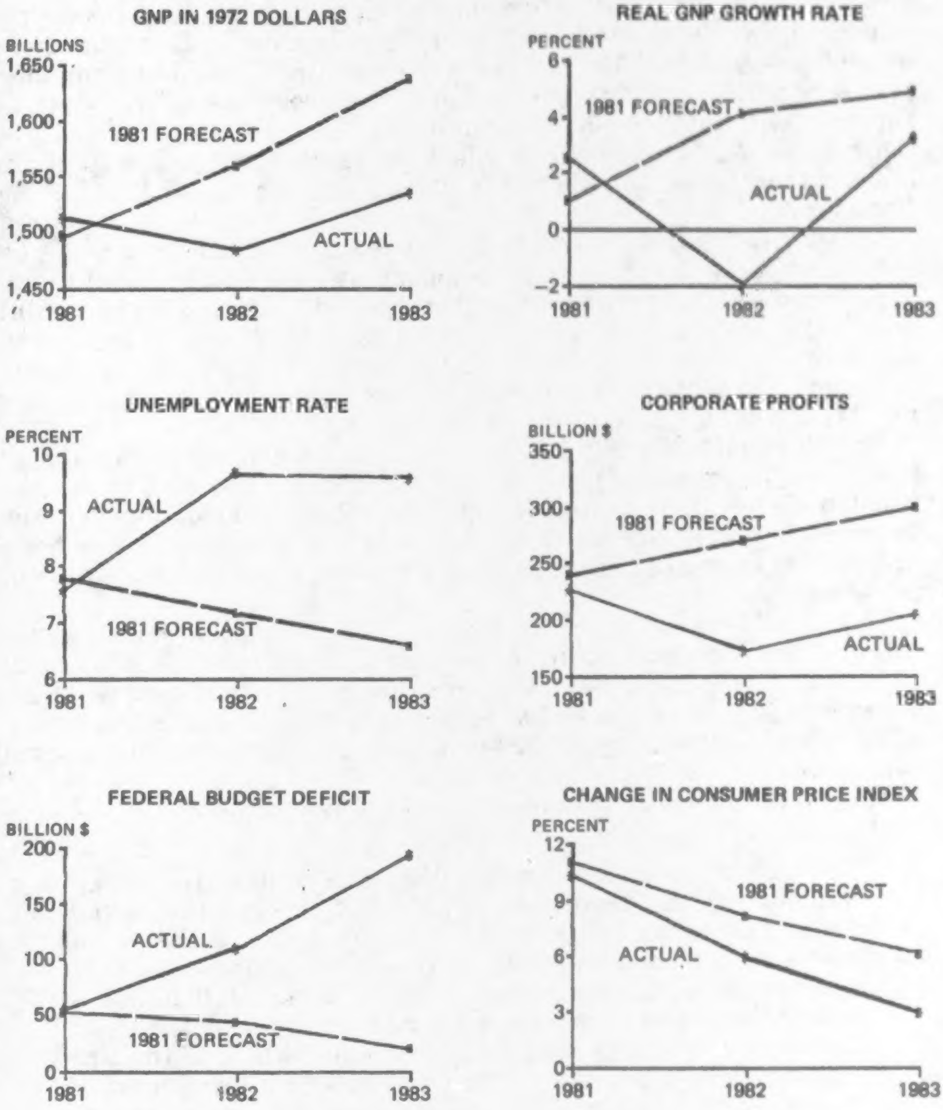
It is reasonable to judge the credibility of this statement by this Administration's performance relative to the goals it set for itself and the Nation in 1981. Real gross national product (GNP) from 1982 through 1984 will have been more than 5.5 percent less than promised in 1981 (Chart I-1). Corporate profits in 1983 were 32 percent below the Reagan forecast. Unemployment last year was three points higher. Two million fewer Americans had jobs. And the deficits which were projected to be zero in 1984 will exceed Reagan's estimates by about $200 billion. Only inflation is better than forecast. In every other respect, this Administration has missed its own economic targets by a wide margin.

For 1984 and after, the Administration has again presented a rosy scenario in which growth continues, unemployment declines, and inflation does not rise. There is little basis in recent history for such a result. The President's budget copes with this difficulty by asserting that "a new fundamental factor," the reduction of inflation expectations, will "work to prevent a renewal of inflation." All available evidence, from market surveys to the term structure of interest rates, suggests the opposite. Because of the deficits, markets rightly fear rising inflation.

Deficits are stimulative. Beyond a certain point, they are inflationary. Current policy will lead to deficits beyond all experience. Monetary policy, the traditional cure for inflation, works as a brake on prices only through recession. Therefore, accelerating inflation cannot be prevented and the recovery cannot be sustained unless deficits are reduced. Yet, the President has presented no program to cut the deficits. The Administration's economic forecast in the budget and the President's optimism in his Economic Report are therefore inconsistent with his program.

Chart I-1.

REAGAN PROMISE AND PERFORMANCE



FISCAL IRRESPONSIBILITY

Ordinarily, the Budget of the United States Government contains the fiscal program of the President and his Administration. The President's Economic Report is meant to describe the economic strategy of the Administration, and to explain how the policies presented in the budget will lead to full employment and stable prices as required by law. The Annual Report of the Council of Economic Advisers (CEA) is meant to appraise the programs of the Federal Government and to make recommendations to the President in light of the goals set forth in the President's Economic Report. In all previous cases, the Council's report has supported that of the President.

This year, the budget has been likened to a bankruptcy filing by the Director of the Office of Management and Budget (OMB), and repudiated outright by the Chairman of the CEA. The President and his Treasury Secretary alone support the budget. But when asked by this Committee whether the budget conformed to economic "common sense," the Treasury Secretary stated, "Obviously not." (1/26/84)

The President himself has already proposed negotiations on an ill-defined alternative program. The status of the budget as the fiscal program of the President is therefore doubtful. And in the Council's Annual Report, no defense of the President's economic program is presented. The Council's Report is instead a critique of that program.

The President's budget calls for "bold, vigorous fiscal policy action." But, no such action is proposed. The President's financial plan calls for budget deficits which under realistic economic assumptions will grow from $192 billion in Fiscal Year 1985 to exceed $248 billion per year by 1989, even if every proposal in the budget is enacted.

The Council's 1984 Annual Report sets out some of the dangers of this course:

> If legislative action is not taken, the cumulative budget deficit would be more than $1,100 billion over the next 6 years. The annual interest on this extra debt alone would represent a permanent cost of about $60 billion in 1989, if interest rates fall as assumed, or at least $100 billion a year if the interest rates remain at their present level . . . The most important long-term economic effect of the prospective budget deficits would be to absorb a large fraction of domestic saving, and thereby reduce the rate of capital formation and slow the potential long-term growth of the economy . . .
>
> The deficits will have effects on the economic recovery as well . . . It is quite possible . . . that the additional demand would concentrate in sectors that are operating close to capacity while the crowding out withdraws demand from industries where a great deal of excess capacity exists. If so, much of the additional demand might be absorbed in price increases while the crowding out adds to unemployment. If this occurs, the resulting recovery

would be slower paced, more fragile, and more inflationary than a more balanced recovery. (Pages 37-40)

COSMETIC PROPOSALS

The President's budget message makes the following cosmetic proposals: (1) that Congress provide the President with an item veto; (2) that Congress propose and send to the states a balanced-budget amendment to the Constitution; (3) that the Administration study the spending recommendations of the Grace Commission; and (4) that the Treasury study tax reform proposals and present a report after the election. The President does not attempt to stipulate the budget savings that would be associated with any one of them.

Item veto authority would apply, practically, to discretionary civilian spending only—less than 20 percent of the budget. The Administration itself has not proposed large further cuts in this area, and is not prepared to say where in civilian discretionary spending line item veto authority might be used.

The proposal for a balanced budget constitutional amendment has already been considered by Congress on its merits and rejected. It has little chance of enactment and little hope of success if it were enacted.

The spending reductions recommended by the Grace Commission are of doubtful worth and would for the most part require policy changes which the Administration has not proposed.

Finally, even the President seems to concede in his budget message—"To those who say we must raise taxes, I say wait." (Budget of the United States Government, Fiscal Year 1985, p. M7)—that increased taxes are required. Several major proposals already exist. The question for the Treasury is not how as a technical matter to raise taxes, but on whom. This question cannot be answered by a study. The stalemate cannot be broken without a change in the Administration's position. More facts are not needed; a willingness to face the facts is.

THE CASE FOR ACTION IN 1984

The President confronts a situation in which the only prudent choices require fundamental revisions in his program. Faced with this, the President has opted to do nothing. He states: "I am committed to finding ways to reduce further the growth of spending and to put the budget on a path that will lead to a balance between outlays and receipts. In 1985 I will submit a budget that can achieve this goal." (1984 Economic Report, p. 9) In the meantime, the President's tactic is to pressure the Federal Reserve to prevent rising interest rates in 1984, a course which in the absence of deficit reduction carries considerable risks.

We cannot afford to wait. Sustained, balanced, and fair economic recovery requires that the basic policy priorities of the Reagan Administration be reversed this year.

Delay has a permanent cost. With every month of present deficits, the permanent burden of interest on our children and grandchildren rises. Government borrowing will consume more of our savings, keeping interest rates high and inhibiting the public and private investment we need today for future growth. Moreover, without action, the high dollar may continue to price American goods out of competition in markets at home and abroad. And the lack of concerted action today to stop our growing trade imbalance could lead to the permanent loss of jobs, markets, and America's competitive edge.

ECONOMIC GOALS

Our national economic goals have been established by Congress in the Employment Act of 1946, as amended by the Full Employment and Balanced Growth Act of 1978.

Our prime national economic goal is to achieve and maintain full employment. Americans want, need, and deserve good jobs. Full employment at reasonable price stability is a legitimate American ideal. It continues to be the standard by which the American people hold their government to account. They are right.

Sustained, balanced, and fair economic growth is the key to reaching this objective. Without sustained growth, sustained progress toward full employment is impossible. Balanced growth is essential; otherwise, some sectors will begin to experience bottlenecks and inflationary pressures while severe unemployment remains in others. Fairness, finally, is a precondition for sustainable political support: if the expansion is not fair, the American people will replace the politicians and the policies which have fostered it.

For the five economic recoveries since World War II that lasted for three years or more, the average annual growth rate was 6.2 percent over the first two years. In 1983, actual growth was 6.1 percent. This was twice as fast as the Administration predicted for 1983. Apparently real growth is now slowing down. But, under the policies recommended in this Report, a growth rate for 1984 near 6 percent would be an attainable goal, provided policy changes were made promptly.

The Administration predicts that real GNP will grow by 4.5 percent over the four quarters of 1984. This unsatisfactory course is probably consistent with policies now in effect. According to the Administration, such a rate of growth in output would reduce the civilian unemployment rate to 7.7 percent by the fourth quarter of next year. Growth would slow to 4.0 percent in 1985, and unemployment would fall to 7.5 percent by the fourth quarter of that year. This would be a decrease of less than one percentage point in the civilian unemployment rate over the two-year 1983–1985 period. After 1985, the Administration forecasts continuing 4.0 percent growth and falling unemployment—a course which is totally implausible under Administration policies.

We recommend a higher 1984–1985 growth path for the economy, achieved by prompt enactment of the policies proposed in this Report. If recent slower growth in the labor market continues, such a path would effect further reductions in unemployment with no significant risk of increased inflation.

More rapid growth in the United States would bring about faster recovery abroad. Many of our allies are just now entering a period of expansion and as they grow their demands for our exports will increase, creating new jobs in our hard-hit export sectors. Exports will also rise if the currently high value of the dollar declines to a more nearly normal range, making American products more competitive in world markets.

The civilian unemployment rate in January was 8.0 percent. The rate for black workers in January was 16.7 percent, with a rate of 47.9 percent for black teenagers. The mean duration of unemployment rose in January to 20.5 weeks, greater than that recorded in any month before 1983. Unemployment remains a social and economic problem of first importance.

An effective strategy against unemployment must proceed on two fronts. First, by sound macroeconomic management, we should restore fiscal stability to government while bringing unemployment down. Second, we should put in place the targeted measures required to do the rest of the job without overstimulating the economy by 1988.

Inflation has stopped progress toward full employment in the past and it threatens to do so again. Virtually all economic forecasters, including the Administration, foresee a rising rate of inflation in 1984. Beyond keeping inflation down in 1984, the essential goal is to prevent further acceleration later on. Changes in the macroeconomic policy mix and certain structural policies are necessary to achieve this; otherwise, high inflation will return, making continued progress toward full employment practically impossible.

The Administration forecasts that the Consumer Price Index (CPI), fourth quarter to fourth quarter, will rise by 4.4 percent in 1984, up from a 3.0 percent rise in 1983. It foresees a rise of 5.0 percent in the GNP deflator, up from 4.1 percent in 1983. Most observers are less optimistic. Forty of forty-seven contributors to the Blue Chip Economic Indicators believe inflation in 1984 will be more rapid than the official forecast. For later years, virtually all economists believe CPI inflation will accelerate unless deficits are reduced.

The Administration prediction that the CPI will rise by less than the deflator also contradicts the opinion of most forecasters (42 of 47 contributors to the Blue Chip Economic Indicators disagree with the Administration's assessment). The Administration should explain and reconcile its inflation forecasts for 1984, and answer charges which have appeared in the press that the CPI forecast was altered for political reasons.

Unfortunately, the Administration has no program other than unwarranted optimism to guard against inflationary surges in the next few years. We advocate more direct steps to deal with inflationary risks, particularly those arising in the international sector.

The law requires that the President set explicit medium-term economic goals. This procedure is intended to achieve a better integration of macroeconomic and structural policies, to improve the Federal Government's economic policy process, and to chart a path toward full employment and price stability.

For the medium term, the Administration projects steady growth, declining unemployment, lower inflation, and a gradually decreasing deficit. But there is no programmatic basis for this pattern of simultaneous progress in all economic areas. The forecast lacks credibility and cannot be realized unless policies are changed.

The President's 1984 Economic Report does not set quantitative economic goals. Instead, the Report arbitrarily forecasts that there will be 4 percent real economic growth each year from 1985 through 1988 and 3.8 percent in 1989. It then calculates the consequences of such growth rates, if by happenstance they were achieved. In the most important instance, the Administration forecasts the unemployment rate for the total labor force (including armed forces personnel stationed in the United States) to decline to 5.7 percent by 1989. Again, there is no relation between this number and the policies the President plans to pursue. Because it does not set a quantitative goal and then describe what policies and programs are needed to reach it, the President's Economic Report does not comply with the goal-setting procedures of the Full Employment and Balanced Growth Act.

II. OUR PROGRAM

We propose a linked, four-part program to reduce deficits and cut interest rates. We propose to reduce the budget deficit by a total of about $200 billion in the next three years and $500 billion over the next five years.

We are prepared to reduce the growth of military outlays to a sustainable rate. We are prepared to raise some taxes, provided new taxes are fair, progressive, and based on ability to pay. We are prepared to see fair reductions in civilian spending, provided the pressing needs of the poor, the unemployed, the hungry, and the homeless are met. We must reorder our budget priorities so that the dollars we spend are targeted to productive investment in our people and our material resources. These steps would bring long-term interest rates down. In return for these actions, we would expect a change in policy by the Federal Reserve, so that real short-term interest rates come down as well, by enough to sustain real economic growth at a more rapid but manageable rate through 1985.

Our direct spending and tax measures will cut the Reagan deficit by $30 billion for Fiscal Year 1985, rising to $166 billion by Fiscal Year 1989.[1] Our program will also permit lower interest rates and higher real economic growth, which will further increase revenues and reduce outlays, and produce a more rapid drop in unemployment. These indirect economic effects will cut an additional $23 billion from the deficit in 1985, rising to $76 billion by 1989.

In all, our program would put the deficit on a firmly declining path. Taking our program as a whole, the deficit can be reduced to $84 billion by 1989. In contrast, if no action is taken, the deficit would rise to $308 billion by that year. Under the Reagan proposals, deficits will rise to $248 billion by 1989.

Consistent with this program, we continue to support specific productive investments that will give a good return. Education, training, jobs, and other proposals we have outlined in this Report will target our scarce dollars on the people, areas, and sectors of the economy which are idle or underutilized and will help prevent inflationary pressures from developing.

The essential elements are as follows:

1. *Reduce the growth of military spending.*—We do not need, cannot afford, and cannot efficiently manage a military buildup on the scale the Pentagon desires. We propose instead that real defense budget authority increases average 4 percent per year from 1985 through 1989. This implies continuation of the policy adopted by Congress in the Defense Appropriations Act for Fiscal Year 1984 and permits a steady real growth of out-

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[1] Savings below Congressional Budget Office (CBO) baseline are $53 billion in 1985, rising to $214 billion by 1989, taking into account both direct and indirect effects.

lays at rates of about 4 percent. Such a program would save $112 billion over five years below the outlays implied in the Administration's military program.[2]

2. A comprehensive review of all non-means-tested entitlement programs.—Major cuts in entitlements, including social security, already have been enacted. An important remaining task is the enactment of a comprehensive program of health care cost control and medicare financing reform. An effective program could save $34 billion in health care outlays over five years and, taking into account $86 billion of social security revisions already enacted, $120 billion will have been saved overall through 1989. A comprehensive review of all non-means-tested entitlement programs might produce additional savings.

3. Institute a fair tax.—We cannot continue to spend 25 percent of GNP while raising only 19 percent in taxes. Any policy of borrow and borrow, spend and spend—as has been this Administration's policy—merely transfers the eventual burden onto future generations, who will pay it either as increased taxes or as inflation.

We favor complete overhaul of the individual and corporate income tax systems along the lines of the Fair Tax proposal, adjusted to raise significant new revenues by 1987. Our proposed path for phasing in such a Fair Tax would increase revenues by a cumulative total of $252 billion through 1989.

4. Lower interest rates.—As soon as the deficit-reduction package outlined here is enacted, the Federal Reserve should change monetary policy so as to produce sustained economic growth at rates rapid enough to assure continued reductions in unemployment. We estimate that a combination of deficit reduction and easier monetary policy can achieve a drop in interest rates of two percentage points, and that such a drop, made fully effective in 1985 and sustained over the four following years, would save a cumulative total of $204 billion in interest outlays.

Finally, our program would permit a *more rapid rate of real GNP growth* than envisaged under the Administration's program, especially in 1984 and 1985. Such growth would provide additional revenues under the tax structure we propose. That *growth dividend* would total, in our estimate, $140 billion over the four years through 1989.

The overriding goal of our program is continued, rapid growth in 1984 under conditions that will not force an abrupt end to the expansion in 1985. To renew America's promise of expanding opportunity, we need sustained growth. We propose to begin a program of economic expansion with a campaign of deficit reduction.

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[2] Compared to the current services outlays as presented in the Administration's budget, our program would save $83 billion over the three-year period 1985-1987, and $154 billion over the five years 1985-1989.

TABLE II–1.—JOINT ECONOMIC COMMITTEE DEFICIT REDUCTION PROGRAM COMPARED TO ADMINISTRATION BUDGET

[In billions of dollars]

	1985	1986	1987	1988	1989
Entitlements	1.7	3.5	6.0	9.4	13.3
Defense	7.0	20.0	28.0	29.0	27.0
Interest [1]	4.0	9.4	17.3	28.7	43.6
Total spending reduction	12.7	32.9	51.3	67.1	83.9
Taxes	17.0	34.0	51.0	68.0	82.0
Total deficit reduction	29.7	66.9	102.3	135.1	165.8

[1] These are the interest savings which stem directly from deficit reduction only. They assume a partial adjustment of interest rates due to deficit reduction, but no change in monetary policy.

TABLE II–2.—JEC PROGRAM COMPARED TO CBO BASELINE

[In billions of dollars]

	1985	1986	1987	1988	1989
CBO baseline deficit	197.0	217.0	245.0	272.0	308.0
Administration deficit [1]	192.0	211.0	233.0	241.0	248.0
Deficit under JEC program [2]	157.0	137.0	122.0	99.0	84.0

[1] As reestimated by CBO, "An Analysis of the President's Budgetary Proposals for Fiscal Year 1985," February 1984.

[2] Assumes deficit reduction program of Table II–1, JEC real growth and monetary policy program, and an employment/relief package of $6.3 billion in fiscal year 1985, $5 billion in fiscal year 1986, and $4 billion in subsequent years.

III. THE PROBLEM

1. The Deficit Crisis

Without major policy changes, the Federal deficit will rise from $195 billion in Fiscal Year 1983—the largest Federal deficit ever recorded—to $308 billion by Fiscal Year 1989.

Should this happen, Federal debt held by the public would more than triple, from $715 billion when Ronald Reagan took office in 1981, to almost $2.7 trillion.

Current policies will increase publicly held Federal debt from 27.1 percent of GNP at the end of 1980 to more than 49 percent of GNP by the end of 1989. This would reverse all of the decline in the debt burden which has occurred since 1960. The Federal deficit will absorb almost 6 percent of the Nation's total output of goods and services in each year of this decade. Not since World War II has Federal borrowing absorbed such a high fraction of GNP. Never before has it continued so long a time.

In Fiscal Year 1983, almost half of the $195 billion deficit was caused by the lingering effects of recession. This was entirely normal under the circumstances, and the deficits did support spending in 1983 and contribute to recovery.

It is customary, however, for deficits to decline as economic expansion matures. Economic growth erases the shortfall in tax revenue, while the demands on goverment by the unemployed and otherwise needy diminish. The budget should move toward balance as the economy moves toward full employment.

The Reagan budgets break this pattern. They transform fiscal policy from a useful tool of economic stabilization into a loose cannon on the economy's deck. We are now entering the second year of what has been, so far, an average recovery. Yet, the deficits of this Administration are not disappearing and will not disappear during the process of economic growth.

Worse, unless policies are reversed, the actual deficit probably will be even higher than the baseline forecast. Present deficit figures are based on the assumption that the economy will grow throughout the decade at a steady annual rate of about 4 percent in real terms. It is much more likely, unless economic policy changes, that renewed high inflation followed by an economic downturn will occur at least once during the last half of this decade. Such an event could raise the annual deficit to as much as $400 billion late in the decade.

Causes of the Deficit

These massive deficits can be traced to three assumptions of the Administration when it took office. One was its belief that a major cut in marginal tax rates would stimulate an investment-led era of high economic growth and enough new revenues to compensate for the rate reduction. The second was its assertion that, because the budget was bloated with waste, fraud, and abuse, significant cuts in civilian programs could be made without imposing hardships. The third was its endorsement of the monetarist/rational expectations proposition that a preannounced and unvarying reduction in the rate of growth of the money supply would—by altering expectations—almost immediately reduce inflation without causing an increase in unemployment or a reduction in economic growth.

When these policies were combined with a huge escalation of military spending, massive deficits resulted.

Revenues fell far short of predictions. The forecasts of the February 1981 Economic Reovery Program promised that rapid growth would generate an 18.1 percent increase in revenues between 1981 and 1983 and a balanced budget by 1984. The period of rapid growth never materialized. The Administration overestimated the investment stimulus of marginal tax cuts and underestimated the depressing effect of its supertight monetary policy. Instead of an investment-led boom, the economiy went into recession. Actual revenues in 1983 were no higher than in 1981, as Table III-1 shows, and future revenues will continue to fall far short of the 1981 forecasts.

TABLE III-1.—THE MOUNTING DEFICITS UNDER THE REAGAN PROGRAM

[In billions of dollars]

Projection	1981	1982	1983	1984	1985	1986
Carter 1982 budget:[1]						
Outlays	662.7	739.3	817.3	890.3	967.9	1,050.3
Receipts	607.5	711.8	809.2	922.3	1,052.6	1,188.5
Surplus or deficit	−55.2	−27.5	−8.0	32.0	84.7	138.2
Reagan March 1981 revision:[2]						
Outlays	655.2	695.3	732.0	770.2	844.0	912.0
Receipts	600.3	650.3	709.1	770.7	849.9	940.2
Surplus or deficit	−54.9	−45.0	−22.8	0.5	5.8	28.2
Reagan fiscal year 1985 budget:[3]						
Outlays	657.2	728.4	796.0	853.8	925.5	992.1
Receipts	599.3	617.8	600.6	670.1	745.1	814.9
Surplus or deficit	−57.9	−110.5	−195.4	−183.7	−180.4	−177.1
Revenue effects of ERTA and TEFRA:[4]						
ERTA		−38.4	−91.1	−133.6	−165.0	−207.7
TEFRA			16.6	35.4	39.7	49.3
Combined		−38.4	−74.5	−98.2	−125.3	−158.4

[1] Budget of the U.S. Government, fiscal year 1982, p. 22.

[2] Fiscal year 1982 Budget Revision, p. 11.

[3] Budget of the U.S. Government, fiscal year 1985, part 9, p. 5.

[4] Ibid., part 4, p. 17.

Much of the structural deficit problem can be attributed to the sweeping and unbalanced tax cuts of the Reagan program. The personal and corporate tax cuts shown in Table III-1, range from $38 billion in 1982 to more than $200 billion in 1986. Some of these cuts were appropriate and, under different circumstances and with different policy mixes, could have been beneficial. But as it was, the revenue losses were huge. The total revenue loss from the Administration's tax and other changes remains far above the revenue growth that can be expected from economic recovery.

The Administration also failed to find billions of dollars of waste, fraud, and abuse to cut from the budget, partly because congressional oversight in past years had preceded this effort. Instead, real cuts were made in virtually every human resource program. These caused hardship, primarily for lower income people, but the recession so increased the ranks of those eligible for entitlement assistance that actual outlays were not reduced. Increased Pentagon spending and rising interest on the national debt more than offset domestic spending cuts and complete the picture of failed fiscal control.

In March 1981, the Reagan Administration argued that its program of tax cuts and military increases would increase the budget deficit only modestly: $18 billion in Fiscal Year 1982, $15 billion in Fiscal Year 1983, and $31 billion in Fiscal Year 1984. By latest estimates, the increase in the deficit in Fiscal Year 1984 will be nearly six times as large as originally predicted.

Before 1981, receipts and outlays measured as a fraction of GNP fluctuated within a small band; the two diverged significantly only during recessions (Chart III-1). The post-1981 pattern promises to be different (Table III-2). Spending is locked in at 24 percent to 25 percent of GNP and revenues are set at 18 percent to 19 percent. The result—a permanent deficit of about 5 to 6 percent of GNP that extends as far into the future as we can see.

Chart III-1.

FEDERAL DEFICITS AND DEBT, 1960-1990

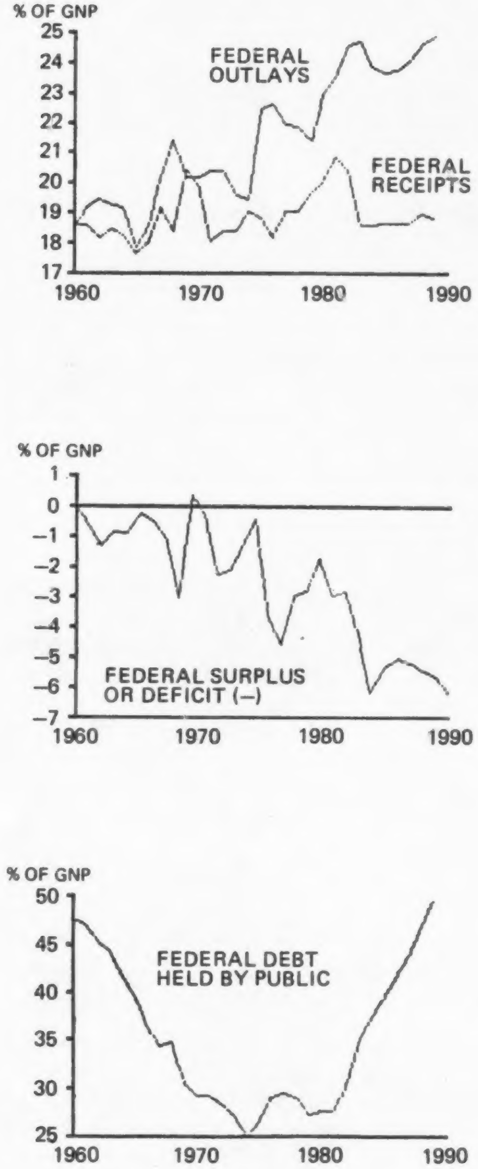

TABLE III-2.—REVENUES, OUTLAYS, AND DEFICITS AS A PERCENT OF GNP

Percent of GNP	Actual		Projected					
	1981	1983	1984	1985	1986	1987	1988	1989
Revenues	20.8	18.6	18.6	18.7	18.7	18.7	19.0	18.9
Outlays	22.8	24.7	23.9	23.7	23.8	24.1	24.6	24.9
Deficit	2.0	6.1	5.3	5.0	5.1	5.4	5.6	6.1
Off-budget	0.6	0.4	0.4	0.3	0.3	0.3	0.3	0.2
Total deficit	2.6	6.4	5.7	5.3	5.4	5.7	5.9	6.3
"Structural deficit [1]	0.5	2.4	3.0	3.3	3.8	4.3	4.9	5.5

[1] Unified budget deficit standardized at 6 percent unemployment.

Source: Congressional Budget Office, Baseline Budget Projections For Fiscal Years 1985–89, pp. 7, 17, 20.

What the Deficits Will Do

The deficit gave a boost to the economy in 1982 and provided, along with the Federal Reserve's shift to easier money, the stimulus that touched off the economic recovery. Real economic growth in 1983 came to 6.1 percent, about average for sustained postwar recoveries. Capacity utilization, nonetheless, remains well below potential, and unemployment is still above the level when Ronald Reagan took office more than three years ago.

If this were in a normal recovery, there would be few sources of short-run concern. Rising incomes and increased job security, along with lower interest rates, would be boosting consumer spending. Business investment would be growing in response to higher utilization rates and the improved outlook. The deficit would be falling, reducing Federal demands in the credit markets and releasing funds for growing household and business credit demands. Sustained economic growth would seem a likely prospect.

In contrast, the outlook today is clouded by the prospect of persistent high Federal deficits and corresponding continued tight money.

THE THREAT OF RENEWED INFLATION

In 1981, the Administration promised that its economic program would break the back of inflation. It is anxious to persuade the world that it has achieved this goal. In the Budget of the United States Government, Fiscal Year 1985, the Administration states:

> In the future a new fundamental factor will work to prevent a renewal of inflation. This new factor is a drastic reduction in inflationary expectations, resulting from the achievement of much lower inflation and the demonstrated commitment of the Administration and the Federal Reserve to control future inflation. (Part 2, pp. 7–8)

This thinking is reflected in the budget's economic assumptions. These project a gradual decline in the inflation rate through the end of this decade. According to the budget, the Administration believes that the GNP deflator will increase by 5.0 percent in 1984. After that, the increase in the deflator is expected to taper off gradually to 3.5 percent in 1989.

At the same time, the budget projects a current policy deficit above $200 billion in every fiscal year from 1986 through 1989.

These deficit and inflation forecasts are inconsistent, and the claim that inflation and inflation expectations have been conquered is therefore false.

During 1983, the structural deficit came to $85 billion, higher than the structural deficit for any postwar year, whether measured in dollars or as a percent of GNP. Under Administration economic assumptions, the structural deficit will rise between now and 1989, providing an increasingly strong upward thrust to the economy even as we approach high capacity utilization.

At $190 billion, the Federal deficit is highly expansionary and threatens to remain so as the economy grows. The expansionary effects of such deficits pose a serious inflationary risk for 1985 and later years. The foundations for overheating and inflation are being laid during 1984.

The problem may even become evident toward the end of this year. U.S. industry operated at 79.9 percent of capacity during January 1984, still well below the 87.3 percent peak utilization rate achieved during the 1978–1980 period. But the unbalanced pattern of activity raises the prospect that bottlenecks, shortages, and orders beyond ability to produce could begin to appear in some industries this year. If recovery in Western Europe and other parts of the world should also generate increased demand, particularly for crude materials that are traded on a worldwide market, the danger will increase. And it would increase sharply if there were a sudden depreciation of the dollar, which will result from a loss of confidence in the macroeconomic policy of the Administration.

When this occurs, the Administration's lack of an anti-inflation policy will put the entire burden of controlling inflation onto the Federal Reserve. The consequences are entirely predictable. Monetary policy, which has been excessively tight during the past seven months, would tighten even further. Interest rates would go up again and a new recession would begin.

The Federal Reserve agrees with this assessment. In its 1983 Midyear Report to Congress, the Federal Reserve Board explicitly abandoned the hope that a once-and-for-all victory over inflation had been achieved:

> The persistence of inflationary expectations is evident both in recent surveys of private opinion and in the behavior of financial markets, in which borrowers remain willing to pay high nominal rates of return on long-term debt instruments. As the recovery progresses, wage and price developments will need to be monitored with great care to make sure that these still-present expectations of inflation are not undergirding a new round of acceleration in actual wage and price increases. (Midyear Policy Report to Congress, July 20, 1983, pp. 7–8)

The only real question in the outlook is *when* the problem will occur. There is, of course, still time to reverse course by enacting measures to reduce the outlay deficits. But the window of opportunity is closing.

A SHORT-LIVED ECONOMIC RECOVERY

The 1985 budget assumes that the economy will grow 4.5 percent in 1984 and then level off to a steady 4.0 percent growth rate through 1988. High deficits and high real interest rates make this very unlikely.

The Council's 1984 Annual Report warns that the budget deficits projected through the end of this decade would impair the economic recovery by discouraging investment in capital equipment, new factories and housing, and by impeding foreign trade:

> The prospect of such prolonged deficits inevitably raises the real long-term interest rate above what it otherwise would have been, reducing current activity in key interest-sensitive sectors and causing the recovery to be lopsided. The most conspicuous example of such current crowding out is the sharp decline in net exports. High interest rates in the United States attract funds from the rest of the world, causing the exchange value of the dollar to rise. The strong dollar makes it difficult for U.S. products to compete in world markets and makes foreign products more attractive to American buyers. In addition, the high real interest rate is no doubt also causing the demand for housing, for some consumer durables, and for some plant and equipment investment to be lower now than it would otherwise have been. (p. 39)

If one compares the long-term government bond rate with the current inflation rate, the real interest rate was 8.73 percent in 1983. When the bond rate is corrected by Data Resources, Inc.'s, three-year inflation forecast, the real rate is lower—6.63 percent—but still historically high. Since corporate bonds and home mortgages carry an interest rate that is generally 150 to 200 basis points above the Treasury bond rate, these figures understate the real interest rate faced by corporate investors and homebuyers.

These high real interest rates will, as time goes on, increasingly obstruct the recovery. The strong recovery in the homebuilding industry during the first half of 1983 plateaued in the second half, as new housing starts leveled off far below previous peaks. Partly in response to a two to three point real interest rate differential, foreign capital flowed into the United States at great cost to exporting and import-competing industries. Without a change in the deficit policy, trade deficits near $100 billion will continue.

How long the economy can continue to grow under current policies depends on the balance between the expansionary thrust of Federal deficits and the restrictive effect of high interest rates. The risks are high and growing, as the Council explains:

> The economy could continue to experience a satisfactory overall pace of recovery for several years with declining rates of unemployment and inflation. But deficits of this magnitude could lead instead to imbalances within the economy that cause the recovery to lose momentum . . . Although no one can be sure just how the economy would behave in the face of such unprecedented deficits, the

> longer the deficits are allowed to persist, the greater are the risks to our economic future. (p. 40)

A THREAT TO OUR STANDARD OF LIVING

In the long run, the major effect of the Federal deficits will be to reduce our potential standard of living by discouraging investment in the new factories and business equipment needed to increase productivity and expand our industrial competitiveness.

Through the end of this decade, the Federal deficit will absorb more than two-thirds of the available savings in the economy—a ratio that has occurred in the past only during years when the economy was deeply in recession. As household and business demand for credit increasingly runs up against the Treasury's needs, high interest rates will discourage long-term investment in plant and equipment and channel available credit into higher yielding and less risky financial assets, just as occurred during the late 1970's.

During 1982 and 1983, net investment in the U.S. economy fell to less than 1.5 percent of GNP, compared to more than 6 percent of GNP during the troubled 1970's and more than 7 percent during the 1960's. If real interest rates rise above current levels, soon we may face a period of negative net investment in which more capital wears out than we put in place. This has not occurred in the United States since World War II.

There are conceivable circumstances under which the Federal Government could run persistent high deficits for the rest of this decade, under a continuing tight monetary policy, without causing interest rates to rise substantially. We have examined each of these and find no comfort in them.

First, a flow of foreign funds into the safe haven of U.S. Treasury securities would permit at least part of our deficit to be financed without reducing the availability of domestic funds for U.S. households and businesses. A very large inflow, however, would further increase the exchange value of the dollar, making U.S. exports more expensive abroad and foreign goods cheaper here—costing jobs in U.S. exporting and import-competing industries. In addition, the credit flow to the United States forces up interest rates among our trading partners, thereby impeding recovery abroad and further weakening the demand for U.S. exports. And the debt we incur will fall on our children and grandchildren.

Second, if the Kemp-Roth tax program had provided an incentive for increased saving by the private sector, the added supply of funds would have tempered the potential rise in interest rates. But the Administration's 1981 personal savings predictions have not been borne out. Instead of rising, the personal savings rate has fallen steadily since 1980 and it averaged only 4.8 percent during 1983. Any increase in savings that has occurred has been the consequence of recovery rather than the tax cut. The net surplus of State and local governments, for example, which is an addition to national saving, was $55.1 billion in the third quarter of 1983, compared to $31.3 billion in 1982.

Third, the interest rate consequences of large Federal deficits could be tempered if borrowing for business investment or mortgage demand were to fall off rapidly as interest rates started upward. Total credit demand would stabilize as would interest rates even under the threat of persistent high deficits. The latest Commerce Department survey of business investment plans indicates, however, that businesses hope to increase investment by about 9 percent in real terms in 1984, despite the recent rise in interest rates. Therefore, in later stages of the recovery, there may be increased rather than decreased private-sector demand for credit.

We have no confidence whatsoever in a rescue by foreign lenders, supply-side savers and investors, or an autonomous decline in business credit demand. Responsibility rests with the Federal Government to take action. It is a matter of concern that this sense of urgency is not shared by the Administration.

2. THE MONETARY DILEMMA

Fiscal policy is not our only problem. Monetary policy too should change as part of an integrated program to reduce deficits and interest rates and sustain economic growth.

Recent monetary policy may be divided into three phases.[1] From April 1981 until July 1982, the Federal Reserve pursued an anti-inflation course. In July 1982, this policy shifted and, until May 1983, the Federal Reserve aggressively and successfully sought to halt the recession. After May 1983, a third phase began, which attempts to prevent rising inflation while not stopping the economic recovery. This phase is, for reasons given below, inherently unsustainable. It should be changed as part of an integrated shift in the macroeconomic policy mix.

The anti-inflation policy of 1981–1982 had two aspects. First, strong action was taken—at the urging of the Reagan Administration—to slow the growth of the money supply, and in consequence interest rates rose and the economy slowed down. The economic slack which resulted, including higher unemployment and spare capacity, deflated demand and forced an end to rapid price increases. At the same time, the Federal Reserve's monetary targets were intended to signal a commitment to long-term monetary restraint, and so effect a permanent reduction in inflation expectations.

This game plan was broken by a series of analytical and forecasting misjudgments. The Administration and the Federal Reserve did not foresee how deep the recession would be, and by how much unemployment would rise, before the anti-inflation objective could be achieved. They did not anticipate the damage that would flow from the recession in the United States to the debtor/exporter economies of the developing world. Nor did they appreciate how the danger of a financial collapse might imperil the world banking system. And the Federal Reserve did not realize the extent to which financial deregulation and other factors would play havoc with monetary forecasting, so that with minor exceptions the announced monetary targets were never met, and hence no added credibility can be said to have been garnered from them.

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[1] The Council's Annual Report fails to present an accurate history of recent monetary policy. The Council argues that the Federal Reserve has consistently followed the prescription of gradualist deceleration in the growth rates of the money stock, and explains all apparent deviations from this course as the unforeseeable consequence of regulatory changes. A reading of Federal Open Market Committee (FOMC) directives would not support such an interpretation, which ignores the decisive interaction of monetary policy and the real economy in each of the past three years.

By July 1982, inflation had indeed been reduced, by as much as in the previous severe recession, that of 1973–1975. However, since the 1981–1982 recession was even worse than its predecessor, in terms of unemployment, the cost of this gain was exceptionally high. In addition, the strains on the world financial system were becoming intolerable.

Congress came to a consensus on the need for a change of monetary policy before the Federal Reserve itself did, and expressed that conviction in the First Concurrent Budget Resolution of June 1982. In July, the Federal Reserve abandoned Reaganomics and ended the Administration's monetarist/expectations experiment.

For 10 months after July 1982, the Federal Reserve worked to bring about economic recovery in the United States and to avert a world financial crisis. Nominal interest rates fell sharply and, since inflation expectations remained relatively high, real interest rates also fell. Money growth resumed at high rates. By early 1983, M2 had been restored so that M2 velocity had fallen back to the levels of 1978; M1 had grown so much that M1 velocity temporarily fell below its historical trend, after having been pushed sharply above it by the tight-money policies of the previous three years.

The economy responded well to the Federal Reserve's policy reversal, which was bolstered by the continuing shift to expansionary fiscal policy. Real growth resumed after a short time lag, paced by sectors which are especially sensitive to falling real interest rates: housing, automobiles, and business inventories. By the second quarter of 1983, it was clear that an average if unbalanced business cycle expansion had gotten underway. Total growth in output and employment were characteristic of the comparable phases of previous postwar business cycle expansions. On the other hand, the composition of the gains in output was skewed: to military rather than civilian government expenditures, to consumption rather than long-term business investment, and with an explosion of imports accompanying an implosion of exports.

In May 1983, fear of inflation again came to the fore, and a third change of course occurred. As late as February 1983, the Federal Reserve believed that its anti-inflation policy, coupled with the expected slow recovery, would produce a durable expansion with a permanently lower inflation rate. At that time, the Federal Reserve expected only weak-to-moderate economic growth for the year (4 percent, 4th quarter to 4th quarter). The Federal Reserve Board, in its report to Congress under the Humphrey-Hawkins Act, expressed optimism that the recovery would be sustained:

> In this past year . . . the progress against inflation has been . . . dramatic. . . . The slowdown was attributable to temporary influences to some extent, but there also has been more fundamental progress. In particular, expectations of inflation are being scaled down, productivity is improving, and there are widespread indications of business and labor adapting their price and wage expectations to the competitive realities of a new, less inflationary envi-

> ronment. (Federal Reserve Board Monetary Policy Report to Congress, February 16, 1983, pp. 1–2.)

Consequently,

> In its initial phases, the economic recovery may be less robust than the average postwar expansion, but, at the same time, the chances that the recovery can be sustained over the long run have been considerably enhanced by the significant progress against inflation in the past year or so. (Ibid. p. 29).

The course of events changed the Board's view. By July, the strength of the recovery was apparent and the FOMC forecast for real economic growth had shifted up by more than a point. In its Midyear Humphrey-Hawkins Report to Congress, the Board wrote, ". . . the recent period of slower price increases has by no means erased the memories of accelerating inflation during the previous two decades." (Federal Reserve Board Midyear Monetary Policy Report to Congress, July 20, 1983, pp. 22–23).

Concern about re-accelerating inflation appears repeatedly in the Federal Reserve's 1983 Midyear Report. It is attributed by the Federal Reserve Board to two factors: the bleak prospects for effective reduction of future deficits, and the persistence of past patterns of price behavior over the business cycle, which typically have meant rising inflation beginning within a year or so of the trough.[2]

The Federal Reserve's Monetary Policy Report to Congress of February 7, 1984, confirms this analysis. In the Federal Reserve's view, there are foreseeable short-term inflation risks—rising commodity prices, a social security tax increase for employers, the expected rise in food prices. These might pass without serious damage, but they could translate into a return of rising inflation expectations if other, avoidable inflation risk factors come into play.

These special factors are identified—a falling dollar, and a too-rapid approach to high rates of capacity utilization:

> One of the possibilities is that the competitive forces associated with the appreciation of the dollar and ample availability of goods from abroad—which have been exerting downward pressures on the rate of inflation—could recede. More fundamentally, as margins of excess capacity diminish—to the vanishing point in a few industries—and as the availability of experienced labor declines, there may be temptations to revert to the pricing and wage bargaining patterns characteristic of earlier years of rapid inflation.

The Report makes it reasonably clear that monetary policy intends to prevent either of the two special factors from occurring, if possible.

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[2] For example, the two most recent long business cycle expansions, 1970-1973 and 1975–1980, both began with inflation at about present rates (5 percent), and saw inflation rise to double-digits within three to five years.

The most recent available record of the FOMC[3] suggests that fears of accelerating inflation are widely shared among the Governors and Presidents of the Federal Reserve System:

> * * * Other members were less optimistic about the prospects for inflation. Several commented on indications of a strengthening in inflationary expectations among participants in financial markets and among businessmen, many of whom were reportedly looking for opportunities to raise prices. Underlying wage pressures, which had been held down by depressed conditions in many industries, were also seen by many members as likely to increase as profits continued to improve. Reference was also made to the adverse implications for costs and for inflationary pressures of a projected decline in productivity growth. One member expressed the view that large increases in M1 during the latter part of 1982 and the first part of 1983 would probably be reflected, after an expected lag, in accelerating inflation by the latter part of 1984. It was also noted that a significant decline in the foreign exchange value of the dollar, if it should occur as many observers expected, would contribute to domestic inflation. In this connection concern was expressed that, as the foreign exchange value of the dollar rose to a relatively high level, the dollar would be exposed increasingly to a precipitate drop, and if such a drop came when the economy was operating closer to full capacity, it would tend to have a much more substantial inflationary impact than otherwise.

The decision of the FOMC in December to maintain monetary restraint at least through February reflects this analysis and was taken with only one dissenting vote. This decision has since been reaffirmed by the FOMC.

The Federal Reserve's analysis of the inflation expectations problem is, in our view, accurate. The Federal Reserve now recognizes that the Administration's policies have launched an ordinary business cycle expansion, from which intolerable inflation consequences eventually are to be expected.

Faced with this dilemma, the Federal Reserve's one-time hope of a permanent victory over inflation and reduction of inflation expectations no longer seems realistic.

It is likely—in the absence of policy changes—that the first sign of returning inflation will be a falling value of the dollar. Should that happen, monetary policy would be placed in a very difficult position. It would be possible, by maintaining very high short-term real interest rates, to offset foreign capital outflows, maintain the value of the dollar, and postpone the day when inflation actually appears. But such a policy would have severe costs in foregone exports and employment immediately, and to investment and international competitiveness over the long run.

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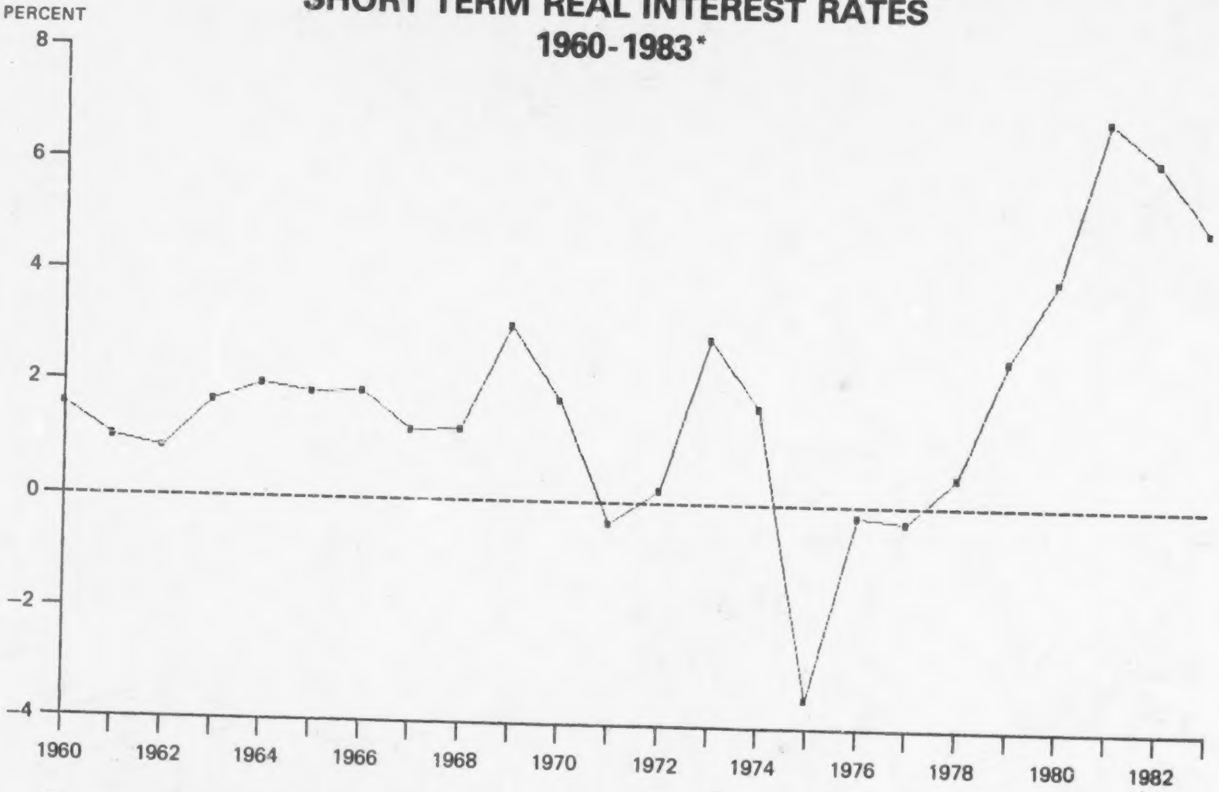
[3] Meeting held on December 19-20, 1983.

Presently, real short-term interest rates are at extremely high levels (Chart III-2). Such rates have remained near 5.5 percent for the past nine months. They are between one and three points higher than in any other industrial nation.

Chart III-2.

SHORT TERM REAL INTEREST RATES 1960-1983*



*Federal funds rate less change in implicit GNP deflator.

These high real interest rates are anti-investment. They contribute to the imbalance in favor of consumer spending in this recovery, which is making the recovery more fragile than it should be. Eventually, inadequate investment will mean a new phase of slower productivity growth, leading to pressures on prices and wages. It is therefore important that mistaken policies—such as a desire to fight inflation with a high dollar—not obstruct a decline in real short-term interest rates once the necessary corrections to fiscal policy have been made.

A high dollar, high real interest rate monetary strategy would be inherently unsustainable. The huge trade deficits such a strategy would cause would destroy it. If we continue to run such deficits, eventually confidence in our currency will flag. The shifts in demand for international financial assets which have worked to raise the value of the dollar would then start flowing the other way. At that point, the dollar would fall sharply despite any efforts to prevent it from falling. Import prices would rise, the cumulative gains against inflation which the policy has brought would evaporate in a very short time. As the Federal Reserve itself has stated, this eventuality becomes even more dangerous as it is delayed, and the closer the economy comes to full capacity utilization.

Note on Federal Reserve Accountability

Federal Reserve accountability in 1983 was improved by the FOMC's agreement to report a "central tendency" of their views on the outlook for real growth, inflation, and unemployment in the year ahead. This "central tendency" is tantamount to an official Federal Reserve economic forecast. It may also be treated as the objectives or targets of Federal Reserve policy, in the sense that substantial deviations above or below the forecast track are likely to generate changes in policy.

The Federal Reserve also displayed commendable flexibility in 1983 in setting and revising its monetary targets. By judicious manipulation of the base for its M2 target at the beginning of the year, the Federal Reserve avoided being trapped into an overly tight policy. And when it became clear that forecasting errors had been made in the case of the M1 target, the Federal Reserve wisely incorporated the overshooting of the first half of 1983 into the base for M1 growth in the second half, thus neutralizing fears that excessive and pointless tightening would occur.

Nevertheless, an unnecessary element of confusion is introduced by continual shifts in the bases against which the monetary targets are set. An absolutely equivalent, and much simpler and clearer, procedure would be to keep the base constant at all times (i.e., always base targets on the fourth quarter of the preceding year), and simply announce revisions as changes in the expected growth rates of the various aggregates over the time period ahead.

Furthermore, we believe it is time for the Federal Reserve to consider changing the form of its monetary targets, from the present range to a simple one-dimensional growth target—a single target number for each aggregate. Under the present system, a discontinuity exists: either the Federal Reserve is within its range or outside it. Analytically, this distinction is much less important than the degree to which monetary growth may be deviating from plan and the reasons for such deviation. The present system erodes public confidence in the Federal Reserve's handling of monetary policy, since all too often the Federal Reserve falls outside its target ranges, and even if the reasons are valid the effect is disconcerting. A single numerical growth target would never be hit exactly, and so the Federal Reserve, in evaluating its own past performance over a given time frame, would have to place emphasis on the reasons why program did not correspond to performance. Such a system would enhance public and congressional understanding of the monetary policy process, permit greater flexibility than the present system, and build confidence in the Federal Reserve's ability to manage monetary policy. We would support changes in law, if required, for a move to the new and more sensible practice.

A major continuing fault of Federal Reserve-congressional relations is the failure of the Federal Reserve to notify Congress directly and immediately of changes in the course of monetary policy. Congress should have been notified, for example, when in May 1983 the FOMC moved significantly toward renewed restraint. Instead, Congress was forced to speculate about this action, like everyone else, until the FOMC directive was published six weeks later. Effective oversight can only be timely oversight. The Federal Reserve must end the practice of making major changes in the direction of monetary policy without informing Congress.

3. International Risk

The fate of our economy depends partly on conditions elsewhere in the world, and these conditions are unstable. Inflationary and deflationary shocks are a continuing threat. We need a gradual decline in the dollar, but not the inflationary free fall which present policies increasingly threaten. The international debt problem has not gone away. And the international energy trade is no less risky than it was only a few years ago.

The Dollar

The dollar is too high and should come down. At the same time, policy must be concerned to avoid too rapid a drop in the dollar, since that would transmit an inflation shock to the economy through higher import prices, and might engender rising inflation expectations. It would be far better for a gradual decline in the dollar to begin promptly, than to keep the dollar high and risk a sharp collapse later on.

The single largest cause of our poor production and employment performance in 1982–1983 was the decline in our international economic competitiveness. Already, this has cost a million jobs. Our merchandise trade deficit was $69 billion in 1983; it may rise to $100 billion in 1984. An estimated one-and-one-quarter percent of real gross domestic product (GDP) was lost in the second half of 1983 alone because of these deficits. The Organization for Economic Cooperation and Development (OECD) estimates that real output losses from foreign transactions will continue to restrain real U.S. GDP growth by as much as one percentage point in 1984, unless the dollar declines.

The high dollar is also responsible for an uncomfortably large proportion of the drop in U.S. inflation over the past three years. As a rough rule of thumb, a 10 percent change in the trade-weighted value of the dollar produces an inverse change in the inflation rate of 1 to 1.5 percentage points. Since 1980, the nominal trade-weighted value of the dollar has risen 52 percent and the real value has risen 45 percent. Over the higher base period of 1973-1979, the real appreciation of the dollar has been 33 percent. Combining conservative approximations, the dollar would account for over three points of the five-point drop in inflation from 1973-1979 to 1983.

The large appreciation of the dollar is due, among other things, to high U.S. real interest rates, the international debt crisis, and until recently the prospects of high returns in U.S. equity markets. These have attracted foreign capital, which in turn have made it possible for the United States to finance its budget deficits without even higher domestic interest rates and further sacrifices in the interest-sensitive sectors.

Sustaining the inflow of foreign capital has become, for better or worse, a critical short-term question. Already, in recent weeks, the tide has shown signs of starting to flow out. The dollar has dropped by 3.5 percent since the beginning of the year. This parallels the fall in the stock market and reflects an international fear that the Reagan Administration cannot cope with the deficit crisis.

In an atmosphere of increasing disillusion, foreign capital inflows can be sustained temporarily, but only by raising U.S. short-term real interest rates. This would attract speculative capital—"hot money"—but it would also reduce domestic investment in plant, equipment, and housing. Soon, other countries would feel forced to raise their short-term domestic interest rates to counter speculative outflows and protect their currencies. The alternatives under this scenario are bleak: either a return to the interest rate wars which helped produce the 1981-1982 world recession, or a bursting of the dollar bubble which would bring rapidly rising prices back to the United States.

So long as the recovery remains on an unsustainable, high interest rate, high deficit course, the high dollar will hang over it like a knife. It will delay the recovery while it remains high, and yet threaten an inflation shock if it falls.

Resolution of the dollar problem is thus inseparable from our broader economic dilemma.

Confidence is the key. Renewed investor confidence in U.S. economic policy can sustain foreign capital inflows while allowing the dollar to return to competitive levels. Basically, investors must be persuaded that the future of business in the United States is bright enough, so that prospective gains from dollar investments are high enough to offset a modest, predictable foreign exchange loss. No combination of policies which threaten either rapid inflation or renewed recession can generate such confidence. But the policies advocated in this Report, which would put the economy on a sustainable, rapid growth path, would have precisely the desired effect.

Debt

Neither the International Monetary Fund (IMF) quota extension approved last year, nor the current round of piecemeal financing arrangements constitute a long-term solution to the debt problem. More fundamental case-by-case debt restructuring may be necessary, particularly should our recovery falter or interest rates rise.

The debt crisis has hit U.S. exporting industries hard. Even though U.S. exports to Latin America account for less than 20 percent of all U.S. exports, growth or decline in exports to this region will strongly influence U.S. trade prospects overall. Between 1979 and 1981, U.S. exports to Latin America grew over 50 percent faster than U.S. exports to the rest of the world. Correspondingly, when the fall came in 1982, it hit exporters to Latin America especially hard. The drop in U.S. merchandise exports to Latin America in 1982 accounted for more than 40 percent of the decline in U.S. exports for that year. In 1983, the trend was not reversed.

The fall in exports to Latin America cost 250,000 jobs in the United States in 1982, in the estimate of the Federal Reserve Bank of New York. By preliminary estimates, the United States lost an additional 150,000 jobs from the same problem in 1983, for a total of 400,000. Job losses are found in every part of the manufacturing and agricultural sectors. Heavy manufacturing, including machinery and transportation equipment, has been particularly affected.

Five external factors have helped cause the economic plight of Latin America. Of these, four can be linked directly to the fiscal and monetary policies of the United States since 1981. They are: (1) the global recession, which cut real exports of the debtor counties; (2) the fall in commodity prices, due to falling demand in industrial countries; (3) the rise in international interest rates; and (4) the appreciation of the U.S. dollar. Oil price increases in excess of U.S. inflation are the one major external factor beyond direct influence by U.S. macroeconomic policy.

Non-oil developing countries owe a total debt of about $550 billion. Of this, oil price increases in the 1970's account for $260 billion, or nearly half. But much of the remainder is attributable to factors over which U.S. policy has a strong influence: real interest rates above the 1961–1980 average added $41 billion; deteriorating terms of trade added $79 billion; and export volume losses stemming from the recession added $21 billion.

The threat of a major debtor default and consequent international payments and banking crisis became extremely serious in 1982, and was one influence forcing a change in U.S. monetary policy that year. In 1983, the acute problem abated. The immediate liquidity problems of the developing countries have been handled with short-term bridge financing, followed by adoption of IMF stabilization programs and agreements from commercial banks to supply additional funds. The effects of somewhat lower interest rates in the United States and of the recovery are being felt. Most of the major debtor countries have IMF-sponsored adjustment programs and most have rescheduled their commercial debts and received, or are in the process of receiving, new funds from the commercial banks.

Longer term questions remain. Some analysts criticize IMF adjustment programs on the ground that the deflationary policies they imply inhibit the investment and economic development which is needed if debtor countries are eventually to reduce the real burden of their debts. The philosophy behind the stabilization programs justifies short-term reduction of living standards in the interest of restoring credit-worthiness and making possible productivity-enhancing and export-enhancing investment. If the criticisms are correct and the longer term objectives are not being achieved, it will prove exceptionally difficult for the major debtors to emerge eventually from their financial crises in an orderly way.

A great question separates short-term financing problems from long-term development issues, and that is the medium-term fate of economic expansion in the developed world. Recent simulation analysis suggests that the industrial (OECD) countries must achieve a minimum of 2.5 percent real growth for the next two years if the present debt-service-to-export ratios of the developing nations are to fall. At OECD growth rates of only 1.5 percent from 1984 through 1986, current deficits in the debtor countries could not be financed, creating a situation of insolvency and risking a crisis.

The most recent OECD growth projections are for 2.5 percent real economic growth through the first half of 1985. Thus, the outlook remains clouded. What is certain is that, if the dollar exchange rate remains unchanged, or if U.S. interest rates remain high, or if the U.S. recovery stalls, due to our failure to reduce the deficits and change the course of monetary policy, the debtor countries will suffer for it and American workers will not escape the consequences for very long.

The outlook would be greatly brightened by a shift to the mix of policies we recommend in this Report. As with the dollar, a systemic problem requires a systemic solution. Sustained recovery in the United States with lower interest rates and a lower dollar would provide the best chance for major debtors to stabilize their international financial condition. The program of deficit reduction, lower interest rates, and gradual decline in the dollar which we recommend in this Report is thus tailored to provide the best hope for a constructive solution to the debt crisis.

Energy

Sustaining the current recovery also depends upon a secure and stable supply of energy. In 1973–1974 and again in 1979, sudden and unexpected increases in the price of oil demonstrated the vulnerability of the U.S. economy to price shocks caused by events and decisions outside our control. In 1973–1974 the price of oil more than quadrupled. In 1979, it more than doubled, contributing significantly to inflation, recession, unemployment, and decreased confidence in the ability of government to manage the economy.

Studies indicate that the increased price of oil *alone* added about 1.8 percentage points to the U.S. inflation rate in 1974, 1975, and 1979, and another 1.3 percentage points in 1980. The same studies note that by 1975 the Arab oil embargo had increased unemployment by 1.7 percent and that the 1979 price shock increased the unemployment rate by 0.4 percent and 1.2 percent the following year. Conversely, it is estimated that the decline of the price of a barrel of oil from $35 to $29 in 1982-1983 reduced inflation by 1 percent.[4]

The Secretary of Energy, Donald Hodel, acknowledges the importance of stable energy prices for the economy, stating that "one of the most dangerous notions we could have is that it couldn't happen again." Nevertheless, the Reagan Administration has eschewed planning for contingencies which could recur, preferring instead to rely on the current good fortune of abundant supplies of oil and the existing level of the Strategic Petroleum Reserve (SPR) as well as the wisdom of the market to allocate resources wisely in the event of a shortage.

By vetoing renewed authority to price and allocate supplies in an emergency, the President signaled his determination to allow the market to perform those functions regardless of the costs to the economy, our society, or the Nation's security. If, for some reason, the export of Persian Gulf oil were cut off, the GAO estimates that the price for a barrel of oil would increase to $98, again increasing inflation and unemployment while reducing growth.

In 1975, to provide some security from the effects of a future price shock, Congress created an SPR which today holds about 390 million barrels of oil, about one-half of the reserve capacity. Congress had previously mandated a minimum fill-rate of 300,000 barrels a day. But the President has been unwilling to fill it that fast, so he and Congress compromised and agreed on a target rate of 186,000 barrels a day. Moreover, funds have not yet been appropriated to complete the project.

According to the GAO, the SPR has the potential to reduce price increases if supply is disrupted, but warns that "the price mitigation potential of the SPR is limited by its current size." [5] Since the creation of the SPR, Congress has again and again stated its unequivocal view that the SPR could provide a necessary measure of insurance for our economy in the event of a cut-off, while its mere existence would discourage the use of oil as a weapon against us. While the Reagan Administration is willing to spend much for defense, it undervalues the importance of such a strategic asset in our national and economic security arsenal.

The Reagan Administration also has cut programs and institutions which could help decrease U.S. dependence on foreign oil, and thus has not reduced our vulnerability to external economic shocks such as occurred in the previous decade. For Fiscal Year 1984, the President proposed cutting solar energy research and development 57 percent, energy conservation research and development 47 percent, conservation grants 99 percent, fossil energy research and development 56 percent, and geothermal energy research and development 72 percent. Congress increased appropriations for these programs, though at levels significantly lower than they had been.

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[4] Cited in "Oil Supply Disruptions: Their Price and Economic Effects," U.S. General Accounting Office (GAO), RCED-83-135, May 20, 1983, p. 31, p. 36; World Financial Markets, Morgan Guaranty Trust Company of New York, April 1983, p. 1.

[5] Ibid., p. 42.

The President has proposed further cuts in these programs for Fiscal Year 1985.

Beyond use of the SPR, the President believes that the United States can rely exclusively on market forces to help our society and economy adjust to an uncertain energy future. While the oil "glut" has kept prices down, some lessons of the immediate past—the need for inventory management and emergency-demand restraint—almost have been forgotten. But, in the long run, we endanger our future if we forget the damage the price shocks of recent years did to the economy.

We are not less vulnerable to energy price shocks today than we were in 1979. After three years of decline, U.S. oil consumption is increasing. The Energy Information Administration projects a 26 percent increase in net oil imports in 1984 to about 5.5 million barrels per day, for a total yearly cost of $60 billion. This represents about one-third of our total consumption. In addition, because our total expenditure on energy, despite decreased use, is today three times what it was before 1973, our economy may be even more vulnerable now than it was 10 years ago.

Although new sources of energy have been discovered since 1973, one-quarter of the world's oil reserves are still located in the unstable Middle East, an area of the world which, in addition to oil, also possesses more than its share of national, religious, and ethnic tensions, and which is the scene at the moment of an increasingly dangerous war. It is imperative, therefore, that the President propose a plan to protect the Nation's economy from contingencies which could recur.

IV. THE SOLUTION

We propose an integrated four-part program to reduce deficits and interest rates and put the expansion on a sustainable and fair path. Each part is linked to every other: taxes, military spending, entitlements, and monetary policy.

Our program, if fully implemented, would cut a total of about $200 billion from the Federal deficits projected for the three years 1985 through 1987. It contains an honest balance between spending cuts and tax increases. As the deficit falls, monetary policy would ease, bringing down interest rates and stimulating investment. Economic growth would be stronger and more assured, while long-term inflation would be lower and employment would be higher. It is a far more balanced program than that presented by this Administration in its 1985 budget.

1. Taxes

Any realistic attempt to reduce the deficits must include new tax measures.

We believe the time has come to replace the current tax code with a new, simplified tax that expands the tax base and reduces marginal tax rates while eliminating many corporate tax loopholes.

The changes made by the ERTA altered the tax burden among income groups and provided significantly more tax relief to those at the upper end of the income scale than to those at the lower end. While most tax rates were reduced by 23 percent during the four-year period 1981 to 1984, the tax rate in the top bracket, affecting only high-income taxpayers, was reduced in 1982 from 70 percent to 50 percent, a one-time 28 percent cut that was followed by further reductions for many upper-income taxpayers in 1983 and 1984.

The result, according to a study performed by the Congressional Research Service, is that upper-income taxpayers received a much larger tax break than their less fortunate counterparts at the other end of the income scale. For example, the real after-tax income of those earning $100,000 or more in 1980 will rise by an average of 5 to 9 percent by 1984 as a result of the Reagan tax cuts. Those with incomes under $25,000 can expect a real increase of 1 percent or even less.

Another study, prepared by the CBO, found that the average family with a 1982 household income of $10,000 or less will see its Federal tax bill go down by $250 by 1985. Those in the $200,000 and up category can expect a tax cut of $40,000 on average, 160 times the benefit received by the average lower income family. For the lower income family, the tax cut amounts to 2.3 percent of 1982 pretax income. For the family whose income exceeds $80,000, the tax break amounts to 8.4 percent of 1982 pretax income.

The Reagan Administration also succeeded in accelerating the long-term shift in the Federal tax burden from corporations to individuals. Corporate profit taxes accounted for more than 21 percent of Federal revenues during the decade of the 1960's. During the 1970's, this ratio fell to just over 16 percent, largely as a result of the reinstatement of the investment credit and adoption of the asset depreciation range system in the Revenue Act of 1971.

During the first years of the 1980's, the corporate share of Federal taxes was slashed in half, to just 8.0 percent. Although some of this erosion was offset by TEFRA increases in other forms of business taxes, the overall result of the Reagan Administration's erosion of the corporate tax has been to shift much of the Federal tax burden onto individual taxpayers.

Over the last three decades, the percent of corporate profits going to taxes has steadily declined, from almost 50 percent during the 1950's to just over 35 percent so far in the 1980's. Many industries pay far less. The steady reduction in the corporate tax rate to 46 percent accounted for some of this. But much of the erosion of the corporate profits tax must be laid at the doorstep of special tax expenditure provisions. These will reduce corporate tax payments by $75.9 billion in 1984, an amount greater than the $66.6 billion that the Administration estimates corporations will actually pay this year.

Our tax program would reverse this Administration's push to put more of the tax burden on lower- and middle-income taxpayers and give enlarged tax breaks to corporations and the well-to-do.

The Fair Tax Act proposed earlier this Congress by Senator Bill Bradley and Congressman Richard Gephardt shows how this could be done. This bill would establish a 14 percent basic rate for the individual income tax. Taxpayers having an income of over $40,000 on joint returns would pay a 12 percent surtax and those with over $65,000 would pay a 16 percent surtax, yielding a top marginal tax rate of 30 percent. The corporate rate would also be 30 percent. The revised tax code would include only a few deductions—those currently used by most households—including mortgage interest, State and local income taxes and real property taxes, charitable contributions, Individual Retirement Account (IRA) and Keogh contributions, and employee business expenses.[1] In addition, some income would be excluded as under current law, including veterans benefits, social security benefits for low-income and moderate-income taxpayers, and interest on general obligation bonds. Most of the special deductions and exemptions for corporations would be repealed under the Fair Tax proposal.

In order to provide increased revenues to match the spending cuts proposed elsewhere in this Report, Fair Tax rates would have to be set slightly higher than in the original Bradley-Gephardt proposal. The basic rate for individuals would be set at 15 percent, the intermediate rate at 27 percent and the top rate at 31 percent. The corporate rate is set at 30 percent. Table IV-1 presents an updated set of Fair Tax rates for individuals and corporations that would achieve our revenue targets through 1989.

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[1] Senator Bentsen strongly endorses efforts to simplify the tax system and improve its equity and efficiency. In 1982, he called (S.J. Res. 206) for an extensive analysis of flat rate tax systems. The Fair Tax is one of many similar flat rate tax systems proposed since then. But until much more comprehensive information is available on these many proposals, especially including their transition effects, he has postponed endorsing any specific flat tax proposal, including the particular variation discussed in this section.

TABLE IV-1.—FAIR TAX RATES

[In percent]

Income category	Marginal tax rate
Single taxpayers:	
Below $25,000	15
$25,000 to $37,500	27
Over $37,500	31
Married taxpayers:	
Below $40,000	15
$40,000 to $65,000	27
Over $65,000	31
Corporations	30

These tax rates do not require any general tax increase for lower and middle-income taxpayers. Virtually every married taxpayer making $40,000 or under and every unmarried taxpayer making less than $25,000 would pay no more tax than under the tax rates in effect in 1984.

Virtually all of the new revenues will come from upper-income taxpayers and corporations. Even among these groups, only those who are currently receiving significant tax breaks will face significant tax increases.

Nonetheless, all taxpayers, regardless of income level, will face lower marginal tax rates under the Fair Tax than under current law. Those taxpayers who pay more under the Fair Tax will find it is because they can no longer take advantage of the multitude of loopholes that have eroded our tax system.

Our revenue estimates for the Fair Tax are presented in Table IV-2. About 17 percent of the projected increase in Federal revenues would come from corporations, while the remaining 83 percent would come from individuals. Our revenues estimates assume a 1986 effective date for the Fair Tax, with some transitional base-broadening in 1985, and take account of the fact that tax brackets would not be indexed under this system.

The Fair Tax marks a significant improvement over the current tax system. It is a simple, progressive tax that nonetheless incorporates much lower marginal tax rates than the current law. Most income, regardless of source, will be treated alike and face the same tax rates. Most itemized deductions, credits, and exclusions would be repealed except for those generally available to most taxpayers. Many provisions that erode the corporate tax base would be repealed and a new depreciation system that does not interfere with investment incentives would replace the current system.

TABLE IV-2.—FAIR TAX ACT REVENUE ESTIMATES

[In billions of dollars]

Category	Fiscal years				
	1985	1986	1987	1988	1989
Current revenues	733	795	863	945	1,016
Individual	329	362	396	438	478
Corporate	65	71	81	85	85
Other	339	362	386	422	453
Fair tax		830	923	1,020	1,097
Individual		396	439	492	546
Corporate		71	89	99	99
Other		362	386	422	453
Increase over current revenues:					
Billions of dollars	[1] 17	34	51	68	82
Percent	2.3	4.3	5.9	7.2	8.0

[1] Transitional base-broadening measures prior to introduction of Fair Tax in 1986.

2. Military Spending

We must have a strong military establishment to defend ourselves and our allies, and to carry out our national commitments and responsibilities as leader of the West. Toward this end, a coherent, well-funded defense program is essential. It is also essential that the defense program be integrated with other necessary elements of national security, including a healthy, balanced, and growing economy.

To provide adequately for our defense needs in a way that serves our national security without wasting resources and overburdening the taxpayer, at least three conditions must be met. The Soviet threat and our own capabilities must be evaluated objectively and must not be underestimated or overestimated. Second, good faith efforts must be made to achieve arms control agreements with the Soviet Union, a principal objective of which should be to reduce the economic burden of the arms race. Third, the budgetary and economic consequences of defense spending should be understood when framing the defense budget.

The Soviet Threat: Defense Expenditures

It is as important to avoid minimizing the Soviet threat as it is to avoid exaggerating it. A first step should be to understand the size of the Soviet military establishment, the resources allocated annually to it, and the trends. The Soviet Union attempts to conceal these facts from public view. However, the U.S. intelligence community has developed a variety of means for measuring Soviet military allocations.

The most widely used measure is based on the Central Intelligence Agency's (CIA's) building block methodology. Under this approach, the CIA identifies the physical components of the Soviet defense effort by counting and keeping track of them over time. The costs of defense activities are then calculated in terms of both dollars and rubles.

As is the case of all international comparisons of economic activities, the results are biased depending on whose currency is used as the measure. Dollar cost estimates create an upward bias that magnifies the size of Soviet defense. A comparison of U.S. and Soviet defense in rubles magnifies the U.S. side. For this reason, the CIA states its comparisons in both currencies. According to the CIA currently, Soviet defense costs in dollars are about 145 percent of U.S. defense costs and, when measured in rubles, about 125 percent of U.S. defense.

The most accurate way to state the comparison is to state it in both currencies or to use the geometric mean of the two. It would be misleading to say that the Soviets spend 45 percent more than the United States. It would be equally misleading to say they spend 25 percent more. The more correct comparison is somewhere between those two figures.

Two other qualifications of such comparisons should be kept in mind. First, comparisons of budgetary allocations measure the resources that go into defense, not defense capabilities. Secondly, when comparing defense allocations, it is more useful to look at the North Atlantic Treaty Organization (NATO) and Warsaw alliances rather than just the two superpowers. NATO, including the United States, spends more for defense than the Warsaw Pact countries, including the Soviet Union. In 1981, it was estimated that NATO spending in dollars was about $300 billion versus about $280 billion for the Warsaw Pact, and the gap was projected to widen in future years. This difference would be narrowed if stated in rubles.

In 1983, the CIA revised its estimates of Soviet defense spending. The new estimates show that Soviet defense spending has been rising at about 2 percent annually since the beginning of 1977, and that the military burden (the percentage of GNP devoted to defense) is 13 to 14 percent. The CIA formerly believed Soviet defense spending was increasing at 4 to 5 percent annually, the historic rate of growth since 1955, and that the military burden had risen during the 1970's from 13 to 14 percent to 14 to 15 percent. Most importantly, the CIA found that spending for defense investment—which includes weapons procurement and military construction—has shown no growth since the beginning of 1977.

Table IV-3 shows U.S. and Soviet average annual outlay trends for total defense and defense investment during 1977-1982. U.S. annual defense spending grew in real terms during this period by an average of 3.5 percent, compared to 2 percent for the Soviet Union. U.S. defense investment grew during this period by 5.8 percent annually, compared to 1 percent for the Soviet Union.

President Reagan stated, in his January 16 speech, that over the past 10 years the Soviets devoted twice as much of their GNP to military exenditures as the United States. It should be pointed out that Soviet GNP is a little more than one-half the size of the United States. Thus, the Soviets would need to support twice as great a military burden in order for their defense expenditures to equal ours.

TABLE IV-3.—DEFENSE OUTLAY TRENDS—UNITED STATES AND U.S.S.R., AVERAGE ANNUAL AND CUMULATIVE PERCENT CHANGES, 1977-82 CONSTANT PRICES

Country	Total defense		Defense investment [2]	
	Annual average	Cumulative	Annual average	Cumulative
United States	3.5	22.9	5.8	40.3
U.S.S.R. [1]	2.0	12.6	2.5	16.0

[1] U.S.S.R. figures derived from CIA estimated costs of Soviet defense.
[2] Investment includes procurement; research, development, testing, and evaluation; military construction; and housing.

Arms Control and Reduction of the Military Burden

There is a broad consensus that U.S. defense spending should grow during the next few years. So long as it is necessary to increase military capabilities in order to respond to threats to our national security, a policy of defense growth is appropriate despite the fact that it increases the military burden and consumes resources that might be employed by the civilian economy. However, there is no inherent reason why defense budgets and military burdens must always increase. If threats to our national security diminish, it may be possible to reduce the heavy military burden.

The primary goal of arms agreements is correctly identified as the avoidance of war, the principal threat to our security. The most urgent goal today is to reduce the possibility of a nuclear war. Recent scientific evidence shows that all human life would be extinguished from a nuclear war because of the "nuclear winter" phenomenon. This prospect underlines the danger of continuing the nuclear arms race.

As a conventional war between the superpowers could escalate to nuclear warfare, the conventional arms race can be considered as dangerous as the nuclear arms race as well as much more expensive. Yet, the likelihood is for continued conventional arms spending increases by the superpowers and probably nuclear arms spending increases as well, even if a new arms agreement is reached. The only alternative to a permanent arms buildup may be to give greater weight to defense costs in the arms negotiation process. In the final analysis, the most effective way to control arms spending may be to make it an explicit objective of the arms control talks.

Defense Spending and the Economy

The Administration came into office committed to increasing the size of the military budget but without a coherent plan for increasing military strength. The spare parts scandal and other recent disclosures of overpricing, waste, and mismanagement of military procurement demonstrate that major cost savings need not come at the expense of security. More dollars alone do not add up to more defense.

Because the Administration's proposed increases were precipitous and because they were not all tied to improvements in defense, the Democratic-controlled House and the Republican-controlled Senate have sharply reduced the defense proposals in each of the past three years. Congressional actions held the increase of real budget authority for defense to 3.7 percent for Fiscal Year 1984. Table IV-4 shows the amounts proposed by the Administration and the amounts appropriated by Congress in Fiscal Years 1982-1984.

Nevertheless, increases in defense spending have been high. Table IV-5 shows the real rates of increase in actual defense budget authority and outlays for Fiscal Years 1981-1984, and the Administration's request for Fiscal Years 1985-1988. Defense expenditures have increased by an annual average rate of 8.1 percent in real terms during the past three years. This surge in defense spending has had a stimulative effect on the economy but it has also contributed to an unbalanced recovery, tilted toward the defense sector, and put the economy at risk over the longer term.

TABLE IV-4.—NATIONAL DEFENSE BUDGET—REAGAN ADMINISTRATION PROPOSALS AND CONGRESSIONAL APPROPRIATIONS, FISCAL YEARS 1982-84

[In billions of current dollars]

Fiscal year	Proposed	Appropriation
1982	226.3	218.7
1983	263.1	244.6
1984	280.5	264.4

TABLE IV-5.—THE ADMINISTRATION'S PROPOSED RATES OF INCREASE IN DEFENSE [1]

[In percentages]

Fiscal year	Nominal budget authority	Real budget authority	Nominal outlays	Real outlays
1981	22.3	12.5	17.5	4.7
1982	19.8	12.1	17.2	7.8
1983	12.0	7.5	12.1	7.1
1984	7.8	3.7	12.7	8.8
1985	18.1	13.0	14.4	9.3
1986	14.6	9.2	14.1	8.4
1987	8.5	3.5	12.4	7.0
1988	8.5	3.8	9.0	4.1
1989	8.4	3.9	7.8	3.3

[1] Based on the fiscal year 1985 Department of Defense Budget.

Because of the recession, the large defense increases so far have not produced the inflation and labor force problems produced by similar defense increases in the past. In the manufacturing sector, the low level of capacity utilization held down prices and the high levels of unemployment have at present assured adequate supplies of labor.

As the economy comes closer to full utilization of resources, the possibility increases that the continued rapid defense buildup will cause problems. As capacity utilization rises, the risks grow. Bottlenecks could occur, especially in the smaller defense industries among the firms specializing in high-technology products, such as semiconductors and electronics, and among subcontractors with competing civilian and military commitments. A consequence would be delays in weapons production and increases in weapons prices. A prolonged rapid buildup could eventually impair productivity growth as the heavy allocation of resources to the defense sector could lead to capital and labor shortages in the civilian sector.

The Administration presently requests increases in real budget authority of 13.0 percent in 1985 and 9.2 percent in 1986, as shown in Table IV-5; after 1986, the rate of rise drops off to 3.5 percent in 1987. However, these real budget authority paths are underpriced in the Administration's budget, because the Administration does not use a defense price deflator which takes proper account of the historical relation between inflation in the defense sector and the rest of the economy. CBO has reestimated the real rate of budget authority increase which is consistent with the Administration's nominal budget request. CBO concludes that the Administration's nominal budget projections would accommodate a real budget authority rise of 7.7 percent in 1986, and this would drop to about 2 percent annually in 1986-1989.[2]

Even using CBO's more realistic estimates, the savings required to bring the Administration's nominal budget authority path for defense down to a level consistent with the 5 percent real budget authority growth path of the 1984 congressional budget resolution and 1985 CBO baseline would require large cuts in budget authority: $92 billion from the Administration's budget request over the five-year period Fiscal Years 1985-1989. Such a growth path would, nevertheless, still imply a very large real increase in military outlays over this period.

To put real budget authority growth on a sustainable path of 4 percent per year would require even larger reductions in the appropriations requested by the Administration: $56 billion in Fiscal Years 1985-1989, in addition to the $92 billion required merely to get down to the 5 percent path, or $148 billion in reductions overall. Such a path would, nevertheless, permit real growth of outlays of about 4 percent in each of the next five years.

A moderate growth path of budget authority by itself does not produce large reductions in the deficit. For example, the five-year budget authority cuts of $92 billion, which are required just to hold real defense budget authority growth to levels in the congressional budget resolution and CBO baseline, produce three-year cumulative outlay savings below the Administration's budget of $78 billion. Yet, when viewed from the standpoint of a deficit-reduction program whose point of departure is the congressional budget resolution or CBO baseline, all of this effort merely prevents the deficit from rising. Even steeper cuts are required to show progress toward a balanced budget.

A 4 percent real budget authority growth path cuts $112 billion in outlays from the Administration's budget through 1989. Compared with the Administration's budget request, these savings are large. But they make only a very modest contribution to deficit reduction of $9 billion below the CBO baseline over the first three years. Over five years, the outlay savings rise to $34 billion below the baseline.

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[2] The reestimates appear in "An Analysis of the President's Budgetary Proposals for Fiscal Year 1985," CBO, February 1984, p. 44.

One way to achieve such savings while improving military efficiency would be to limit the cost growth of defense programs. The Administration's defense purchases deflator is compared in Table IV-6 with that of the CBO, which is more consistent with the historical relationship of defense inflation to general inflation.

Discretionary inflation adjustments can be considered a defense hardware counterpart to civilian cost-of-living adjustments (COLA's), although these adjustments are not required by law and do not apply to military pay. Through this mechanism, the Defense Department is permitted to increase the purchase prices of goods and services along with increases in defense inflation.

The effect of the Administration's understatement of expected inflation is to understate expected dollar outlays and budget authority requirements consistent with a given real budget authority growth path. Thus, to realize the Administration's constant-dollar military growth objectives under realistic inflation assumptions, even higher dollar expenditures and higher deficits will be required than the Fiscal Year 1985 budget allows.

Congress has the authority to intervene in this process. By restricting discretionary inflation adjustments in defense programs to something less than the full amount of defense inflation, and thus requiring the Administration to live within its own cost growth estimates and its own budget, Congress could bring pressure on the Defense Department to make economic choices between programs which would increase the efficiency of the defense procurement process.

TABLE IV-6.—DEFENSE COMPOSITE DEFLATOR

[Percent change]

Fiscal year	Administration	CBO [1]
1985	4.5	5.9
1986	4.8	6.3
1987	4.8	6.3
1988	4.5	6.1
1989	4.4	6.0

[1] Revised.

Prior-year increases in budget authority also influence current and future outlays, because only a portion of the amount authorized for purchases is spent in the first year after it is authorized. Here, too, Congress is not helpless. Congress can direct the cancellation of unnecessary weapons and delay the procurement of others. Such steps would facilitate reaching a sustainable defense expenditure path, without jeopardizing readiness or our ability to acquire truly needed systems.

Proposals to "stretch out" the Administration's proposed buildup merit careful consideration. While it is sometimes argued that longer procurement periods mean higher unit costs, such a course might help prevent procurement bottlenecks and so actually lower unit costs and the rate of inflation in the defense sector.

Given the high levels of present expenditures and stocks of weapons and materiel already in the inventory, growth rates of real budget authority in the 4 percent range would enable the Defense

Department to continue procuring significantly larger quantities of weapons and to pursue a program of modernization and enhanced readiness. Such a real growth rate implies a strengthening of the force structure if the resources allocated for defense are prudently managed. Because it provides a more moderate rate of spending in the next few years than that proposed by the Administration, it may represent a more sustainable course of action and one which could be achieved in a more economical way.

3. ENTITLEMENTS

A balanced and credible plan for reducing Federal deficits in future years must also limit the growth of entitlement programs. We believe it is time for a thorough review of all non-means-tested entitlements programs. Entitlements have been, alongside defense, the fastest growing component of Federal spending in recent years. There have been important successes. We have lifted many elderly Americans from poverty and we have reduced the incidence of hunger. Some of these successes are now imperiled by recent Reagan Administration cuts, while other needs go unmet. And yet, entitlement costs continue to rise.

A thorough review of entitlements should consider how savings might be achieved in each of the non-means-tested entitlement programs. It must examine whether the continuing case for full cost-of-living indexation justifies the likely future cost. It must ask whether wealthy recipients are getting more than a fair share of benefits. It must seek ways to assure that present gaps in the safety net are repaired. Only a balanced, bipartisan review of all entitlement programs can hope to produce a successful package of reforms for this vital part of the budget.

1983 spending on entitlement programs was $400 billion, nearly half of the Federal budget. Under current policy, outlays for these programs will grow to $570 billion by 1989. Because increases in defense spending are even larger, however, the share of entitlements in the budget will be falling.

Retirement and disability programs [3] account for half of all spending for entitlements and approximately one-fourth of the federal budget. Health programs, principally medicare and medicaid, comprise another quarter of the entitlement category and about 11 percent of the budget, while the remaining quarter consists of payments for unemployment insurance (UI) and various forms of cash and in-kind assistance to low-income individuals and families.

Pending results of a full review, there are specific measures on which action can be taken now.

Health Care Cost Control

Enormous increases in the cost of medical care are jeopardizing access to health services for millions of Americans and undermining the viability of Federal health programs for the elderly and the poor. Health care expenditures, which grew from $26 billion to $75 billion during the 1960's, reached $322 billion in 1982. Since 1970, medical costs have risen from 7.5 percent to 10.5 percent of GNP, as per capita spending on health has more than tripled.

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[3] Including social security, civil service retirement, pensions and disability payments to veterans, and the Supplemental Security Income (SSI) program for the elderly poor.

Price increases for medical care consistently have exceeded general inflation rates. Except for a brief period under wage and price controls in the early 1970's, hospital and physician costs have risen at double-digit rates for all of the last decade. Driven by increases of 13.3 percent for hospital room rates, health care costs increased by 11 percent in 1982, while inflation overall slowed to 3.9 percent. In 1983, medical costs rose by 8.7 percent—still nearly three times as quickly as all other items.

Massive inflation in health costs is the main reason for escalating Federal expenditures on medicare and medicaid. Medicare, which pays hospital and doctor bills for the elderly and disabled, now accounts for over 7 percent of all Federal spending. Program costs, which amounted to $56.8 billion in 1983, are expected to double by 1989 if nothing is changed.

Meanwhile, the payroll tax revenues which finance hospital expenses under medicare cannot keep pace with the rising cost of care. Under conditions of moderate economic growth, earnings covered by the payroll tax are expected to increase by 6.8 percent annually for the next decade, while hospital services for medicare beneficiaries will increase by 13.2 percent a year. This imbalance could drain the hospital insurance (HI) trust fund as early as 1990.

Only about two percentage points of the projected increase in hospital spending is attributable to the health needs of a larger (and older) medicare population. The rest, reflecting rising hospital costs, is explained by higher prices for inputs (like labor and supplies), increased admissions to hospitals, and greater use of expensive, high-technology forms of treatment.

Rising health costs also mean steep increases in spending under medicaid, which provides health benefits to over 20 million low-income persons, and the Supplementary Medical Insurance (SMI) program, which covers physician and outpatient expenses of medicare beneficiaries. Since general revenues finance part of both programs, neither faces the prospect of insolvency. Nonetheless, medicaid costs are projected to increase from $19 billion in Fiscal Year 1983 to $32.5 billion in Fiscal Year 1989, while SMI outlays—now about one-third of medicare spending—could grow by 16 percent a year. Stronger efforts to brake the cost spiral would lessen these pressures on the Federal budget.

We recognize that no single approach, by itself, will solve the problem of soaring health care costs. An effective, long-range strategy should seek to alter both the supply and demand for health care services. For example, we should take steps to increase the supply of health care personnel and broaden the availability of alternative forms of care. Health maintenance organizations (HMO's) and other practices which offer quality services at competitive rates should be encouraged. And broad steps are needed to improve nutrition and other living habits and to provide better health education and preventive care.

Last year, Congress moved to exert greater Federal control over hospital costs by changing the reimbursement system under medicare. Instead of reimbursing hospitals for the cost of treating medicare patients, the program will phase in a prospective payment system which sets rates for 468 illness categories. Hospitals will classify patients according to these categories (known as diagnostic-related groups or DRG's) and receive a fixed payment per case from medicare.

It is too soon to see results from this new payment system, or know how much leverage medicare—which now provides about 37 percent of hospital revenues—will have over medical prices. At the request of this Committee, the GAO is currently monitoring the effects of the new DRG payment system on hospitals, to see what happened to prices, the quality of care to medicare patients, hospital profits, and other aspects of the health care system. The GAO report should be ready later this year.

The prospective payment reforms under medicare do not constitute a full strategy toward more effective cost containment. Nothing prevents hospitals from shifting extra costs to patients not covered by medicare (and their insurance companies). Moreover, while the fixed reimbursement rates may discourage unnecessarily lengthy hospital stays, hospitals may be prompted to be more selective in their admission policies—treating less-sick patients and some patients who could have been cared for at lower cost as outpatients. And, except in a few states, physician fees and other outpatient services are not subject to restraint.

Several states, including New Jersey, Maryland, Massachusetts, and New York, have implemented prospective payment systems which apply to all payers—not just medicare. While the state experiences vary somewhat, on the average these regulatory programs have held down increases in spending on hospital care by 2 to 3 percent per year. Further, state rate-setting efforts generally have not led to perverse increases in hospital admissions or longer stays. Legislation introduced by Senator Edward M. Kennedy and Congressman Richard Gephardt would apply these principles to all states.

We favor consideration of legislation to encourage all states to implement cost restraint programs. These efforts would apply prospective payment methods across the board and aim to reduce cost increases for outpatient and physician services as well as hospital care.[4]

The savings from more effective cost restraint could be substantial—and should grow as states gain experience with different approaches. If state cost-restraint programs are developed nationwide, Federal deficits could be lowered by as much as $33 billion from fiscal year 1985 through fiscal year 1989.

Suggested Medicare Revisions

The Administration has advocated changes in the benefit structure of medicare which would require beneficiaries to shoulder a larger share of the costs, particularly for hospital stays. Higher deductibles and co-payments, the Administration has argued, will introduce greater cost-consciousness on the part of patients and reduce unnecessary hospitalization and treatment.

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[4] Senator Bentsen opposes limiting Congressional consideration and review of options for reining in medical costs to this single proposal.

Because of the tax-free status of health insurance and the heavy reliance on insurance to finance health care, existing incentives to restrain costs are relatively weak—for patients and providers alike. In 1982, private insurance plans, government programs, private charities, and other third parties financed 68 percent of health expenditures and 88 percent of hospital services.

But the current structure of medicare already places heavy financial burdens on many elderly and disabled beneficiaries. Medicare pays only about 45 percent of all health expenditures of the elderly. While some beneficiaries have private insurance which covers services not paid for by medicare, out-of-pocket expenditures for services like nursing home and dental care, prescription drugs, and the existing premiums and deductibles under medicare can be substantial. On the average, out-of-pocket health costs exceeded 10 percent of income for the elderly, and families with less than $5,000 of income spend 21 percent of it on health care.

We question whether greater cost-sharing would have the desired effects on the efficiency of health care. It is not reasonable to expect persons who are ill to "shop around" for less expensive forms of treatment than their physicians have recommended. Similarly, utilization of hospitals is primarily determined by physicians, not by patients.

As an alternative to further cost-sharing, we recommend a review of other options in the financing of medicare. Different combinations of revenues from payroll and other taxes and from higher premiums should be considered. One promising approach, set forth by Karen Davis of Johns Hopkins University, would merge the HI and SMI trust funds and set a single new premium based on the income of the beneficiary. The combined trust fund would still be financed partly by payroll taxes and general revenues, with new funding raised in an equitable manner. The new premium structure need not require low-income beneficiaries to pay any more than they do now. In contrast to cost-sharing, some use of an income-related premium would not tend to limit access to care or impose the heaviest burdens on persons who become ill.

New revenues raised to prevent insolvency of the medicare trust fund would correspondingly reduce Federal deficits. Effective cost restraint programs might reduce the long-range financing needs by as much as 60 percent, making additional revenues for medicare unnecessary until later in the next decade.

Means-Tested Programs

Benefit programs for which eligibility depends on needs amounted to $60 billion in 1983, less than 20 percent of entitlement spending. Most of these programs have already endured heavy cuts. Spending levels for many means-tested benefit programs are barely above Fiscal Year 1981 levels, despite conditions of severe recession which normally would push up costs by increasing the numbers of people who qualify for aid. Cuts of 13 percent per year in 1981 and 1982, for example, removed several hundred thousand families from the Aid to Families with Dependent Children (AFDC) program, and reduced benefits to many more. Such hardships followed a steady erosion of the purchasing power of these payments, which are not automatically adjusted for inflation.

Legislative changes adopted since 1981 reduced spending on major means-tested programs by roughly $24 billion from 1982 to 1985. Only two programs—SSI and the supplemental nutrition program for women, infants, and children (WIC)—received additional resources. In real terms, funding for entitlements and other human resources programs targeted on low-income people has been reduced by 25 percent since Fiscal Year 1981. No other portion of the budget has been cut as severely.

TABLE IV-7.—SPENDING ON MEANS-TESTED ENTITLEMENT PROGRAMS

[In billions of dollars, by fiscal year]

Program	1981	1982	1983	1984 (estimate) [1]
Medicaid	16.9	17.4	19.0	20.7
AFDC	8.5	8.0	7.9	8.0
Food stamps	11.2	11.0	11.8	11.3
Child nutrition	3.8	3.4	3.3	3.4
WIC [2]	0.9	0.9	1.2	1.2
Housing assistance	6.9	8.0	9.3	9.8
Low-income energy assistance	1.8	1.7	2.0	2.0
Veterans pensions	3.7	3.9	3.9	4.0
SSI	7.2	7.7	8.7	8.3

[1] Estimates based on economic assumptions of Feb. 1984 baseline budget projections.

[2] Women, infants, and children program.

Source: Congressional Budget Office.

Attempts to derive further savings through even narrower "targeting" of the means-tested programs will only compound the burdens on the working poor—the main group victimized by the existing set of cutbacks. In most states, the income limits which disqualify families from cash welfare benefits are below $5,750 a year, or less than 60 percent of the poverty line for a family of four. Families terminated from AFDC also often lose medicaid coverage without obtaining equivalent health benefits from their jobs or another source. Other welfare program changes which especially hurt the working poor include tighter deductions for child care and work expenses, lower income limits on participation in the food stamp program, and diminished Federal subsidies for school lunch and other child nutrition programs.

The Reagan Administration continues to press for even deeper reductions in many of these programs. We urge that such moves be resisted. Neither do we believe that much more can be saved through elimination of fraud and abuse in these programs. Helping people escape dependence on public assistance by preparing for and finding permanent jobs offers the surest and fairest way to control these expenditures in the future.

Social Security

To deal with immediate and longer range financial pressures on the social security system, major revisions were adopted in 1983. The combination of additional payroll tax revenues and cost savings under this legislation will reduce the Federal deficit by $8.6

billion in 1985, $8.8 billion in 1986, and a total of $86.2 billion over the period 1984 through 1989. While the deficit estimates from CBO and the Administration already reflect these savings, the extent of changes made in social security—the largest of the non-means-tested entitlement programs—should be recognized in devising a balanced approach to deficit reduction.

The increases in social security revenues result principally from extending coverage to new Federal workers and all employees of nonprofit organizations; taxing 50 percent of social security benefits going to higher-income recipients; and raising payroll taxes in 1984, 1988, and 1989. Cost savings were achieved chiefly by postponing the annual cost-of-living increase from July to January; gradually raising the retirement age from 65 to 67 after the turn of the century; and allowing the COLA to be based on wage increases instead of the CPI in years when trust fund reserves run low.

This package constituted a properly balanced response to the problems facing social security. Changes in the benefit structure—such as the higher retirement age—were phased in slowly, allowing people time to adjust their retirement plans. Except for the delay of the cost-of-living increase, benefit cuts to current recipients and persons nearing retirement age were avoided.

We do not favor further changes in social security now.

Cost-of-Living Adjustments

Many Federal transfer programs provide for automatic adjustment of benefits to keep pace with inflation. Typically, the index used to make this adjustment is the CPI. Since directly indexed programs account for roughly one-third of all Federal expenditures, each percentage point increase in the CPI adds about $2.6 billion to outlays.

Valid questions have been raised about the suitability of the CPI as a measure of the cost of living. Concerns that the treatment of homeownership overstated costs led to the introduction of a new measure of rental equivalence, which did resolve that problem. However, because the CPI relies on a fixed market basket of goods and services to trace price changes, it cannot readily capture important changes in consumer behavior. The reduced consumption of gasoline in the wake of the price shocks in 1973, for example, would not be reflected until the next revision of the index (usually at 10-year intervals).

Conceptually, there are advantages to alternative indices as the basis for COLA's in transfer programs. For example, one index of personal consumption expenditures (known as the PCE chain index) is able to reflect changing consumption patterns by regularly updating the market basket. Another possibility is wage indexing, which would give recipients of transfers the same inflation protection as wage earners. Since taxes on the working population finance these benefits, wage indexing is a fair way of linking changes in benefit payments to changes in general economic performance. Under wage indexing, recipients of benefits will suffer some losses of purchasing power in periods of inflationary price shocks. But, at other times, they will share in productivity gains that foster real wage growth, from which they are currently excluded.

Currently, since wages are rising more rapidly than prices, wage indexing would not restrain outlays of government programs. But, during the most recent episode of double-digit inflation, alternative indices would have yielded major savings. In Fiscal 1981, according to CBO estimates, wage indexing of entitlement programs would have saved more than $8 billion, while the PCE chain index would have saved $12 billion. Both of these methods should be considered, as improvements to the current system are debated.

4. Monetary Policy

With a sharply tighter fiscal policy, the Federal Reserve's task is to maintain real economic growth.

Under current policy, real growth is slowing. In 1983, growth rates were satisfactory though not exceptional;[5] they risk becoming unsatisfactory in 1984. Moreover, fiscal responsibility demands that we enact policies that will further reduce fiscal thrust in 1985 and later years, and these steps will affect growth expectations and the pace of investment now. Under these circumstances, it falls to monetary policy to maintain confidence in continued recovery, in growth, and in the prospects for profitable investment.

It is difficult to compute the precise adjustment that monetary policy must make. Important aspects of the situation are imponderable. No one knows the degree to which reduction of future deficits will depress present expectations of inflation and what effect that might have on present business investment. No one knows the degree to which failing interest rates will lower the dollar. If the dollar does fall, exports will improve, but the size and speed of that adjustment is uncertain. Monetary policy will therefore have to adjust with extreme flexibility and discretion, focusing always on ultimate objectives rather than on intermediate targets, whether these are expressed in terms of monetary aggregates or interest rates.

Certain general guidelines for monetary policy are possible. We know that the reduction in real interest rates in 1982—from 9.9 percent in the second quarter of that year to 3.1 percent in the first quarter of 1983—had powerful effects on the demand for housing, automobiles, and other interest-sensitive durable consumer goods. Real short-term interest rates have since been pushed up by the Federal Reserve, which means that some of the demand which was unleashed last year is again being pent up. A lowering of short-term rates would lower the whole term structure of rates and again bring a large number of home seekers and auto buyers into the market, and this would act to sustain economic growth.

Some reduction in long-term real interest rates will occur as the direct consequence of adopting a responsible fiscal program. However, econometric estimates suggest that this part of the shift may be relatively small. Most estimates attribute only 100 to 200 basis points of current long-term real interest rates to deficits. Thus, a fall of 50 to 100 basis points in long-term interest rates might be expected if the stream of future deficits is cut by half. This would help but it would not be enough; a shift in short-term rates would also be necessary, so as to move the whole term structure of rates downward.

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[5] In our 1983 Report, we wrote, "The achievement of 5.5 to 6 percent real annual growth in the first full year of recovery is a realistic goal." Actual growth for this period was 6.1 percent. The Administration had presented a forecast of much weaker recovery.

Such action would probably bring about a realignment of the dollar, since "hot" money seeking high real short-term returns would flow elsewhere. However, this movement should be moderate, since the improved prospects for sustained recovery would attract some long-term capital to offset the speculative outflow. Over the medium term, import demand would slow, export demand would improve, and so the competitive position of American industry would be reestablished. Improved investment prospects would mean better productivity performance over the medium to long run. These benefits, which also mean more and better jobs for American workers, will lead to improved prospects for price stability in the long run.

Present U.S. short-term real interest rates are between one and three points higher than in any actual or potential reserve currency nation. How great a fall in the dollar would result from a reduction in such real rates of return depends on many international circumstances not within our ability to predict or control, including especially the degree to which other central banks react to our policy shift by reducing their own real interest rates.

Nevertheless, if we move first, it is highly likely that a significant shift in our monetary policy would lower the dollar and so act to restore U.S. industrial competitiveness on the international markets. Exports would rebound—sooner and less durably if other nations do not follow our example, later but more durably if they join us in a general return to higher rates of economic growth.

Our alternative is an integrated one. We favor immediate action to reduce future deficits, and so place government finance on a sound footing, reducing fears of excessive future stimulus and inflation. As these measures are enacted, we favor a change in the Federal Reserve's monetary strategy. These actions together should bring the whole term structure of real interest rates down by about half, or by two to two-and-a-half percentage points.

We understand the argument that only high current and expected real rates of interest can hold back a floodtide of inflation expectations under the current course of expected future deficits. We propose to take care of the underlying problem of excessive future fiscal thrust as the first order of legislative business. Such action would make essential the easing of monetary policy, which we have described here. Lower long-term and short-term interest rates, achieved by deficit reduction and a monetary shift, would assure that U.S. economic growth continues at a pace sufficiently rapid to reduce unemployment and foster high rates of productivity growth and business capital investment.

V. EMPLOYMENT AND COMPETITIVENESS

1. EMPLOYMENT

While our alternative monetary and fiscal policies for sustainable, balanced, and fair growth should yield a greater decline in the jobless rate than the President sets forth, such policies will only accomplish part of our task. While we know that to do so will be difficult, our objective should be to go from a reduced unemployment rate achieved through macroeconomic policies by 1986 toward full employment without creating inflationary pressures.

The President has acknowledged that the Federal Government must play an important role in reducing unemployment. In his 1983 Economic Report, he stated that ". . . the government should focus its attention on those groups that will continue to face high unemployment rates after the recovery has begun." We agree with this statement.

The Bureau of Labor Statistics (BLS) found that 26.5 million persons encountered unemployment during the 1982 recession—22 percent of all persons who were in the labor force during any part of 1982. Blacks and Hispanics were disproportionately represented among persons who encountered some unemployment in 1982: the proportion was 33.4 percent for blacks and 27.1 percent for Hispanics.

The number of people working part time for economic reasons was 5.9 million in January of 1984—somewhat reduced from the levels in the midst of the recession but still very high. It is unusual at this stage of the economy's recovery for so many people who want full-time work to find only part-time jobs. In addition, there has been an increase in the number of discouraged workers from 1.568 million in 1982 to 1.641 million in 1983. One out of every three discouraged workers is black.

TABLE V-1.—UNEMPLOYMENT RATES FOR CIVILIANS, WOMEN, MINORITIES, AND TEENAGERS, 13 MONTHS AFTER UNEMPLOYMENT RATE PEAK

Month	Civilians	Women	Minorities	Teenagers
November, 1950	4.2	5.2	NA	9.5
October, 1955	4.3	5.1	8.8	11.0
August, 1959	5.2	5.6	10.6	16.1
June, 1962	5.5	5.8	11.0	13.6
September, 1972	5.5	6.7	10.0	16.3
June, 1976	7.6	8.4	13.4	18.5
August, 1981	7.4	7.7	14.7	18.3
January, 1984	8.0	7.9	15.6	19.4

Source: Bureau of Labor Statistics.

The recovery has begun, but more than nine million Americans are jobless and unemployment is likely to remain very high for the indefinite future. For blacks, the unemployment rate in January 1984 was 16.7 percent, more than twice the unemployment rate for the Nation. The black teenage unemployment rate of 47.9 percent is almost three times higher than that of white teenagers. Four hundred and thirty-five thousand more blacks are unemployed now than when the Administration took office.

The improvement in the employment situation of blacks was concentrated among adults—particularly men, whose jobless rate dropped from 19.9 percent in January 1983 to 14.8 percent in January 1984. Black women achieved more modest gains as unemployment fell from 17.4 percent to 14.3 percent during this time. The job market for black youth, however, has not brightened at all; fewer than one-fifth of black teenagers are working, and jobless rates—for both males and females—fluctuated around 50 percent throughout the year. In contrast, between January 1983 and January 1984, unemployment rates among whites declined from 8.5 percent to 6.3 percent for adult men; from 7.9 percent to 6.0 percent for adult women; and from 20.1 percent to 16.2 percent for teenagers.

Those who have been out of work longest have gained little from the recovery. The number unemployed for a year or more has fallen only slightly, from 1.41 million in January 1983 to 1.36 million in January 1984. The mean duration of unemployment actually increased, from 19.4 weeks to 20.5 weeks, over the same period. As a result, a combined measure of the extent and length of joblessness has remained virtually unchanged in the last year.[1]

These rates of unemployment point to a basic flaw in the Administration's program—the lack of specific microeconomic measures to address unemployment in certain demographic groups which do not benefit from improved economic conditions in general.

The answer lies in supplementing our fiscal and monetary proposals with targeted structural programs which are geared to creating employment and training opportunities, primarily in the private sector, for those people who have experienced special labor market difficulties.

In general, the following groups should be the intended recipients for such a targeted approach:

First, special measures are required for youth. In January 1984, the overall teenage unemployment rate was 19.4 percent, and has shown virtually no change for three months. The problems faced by black youth were even more staggering.

Effective help for our youth must begin in the schools, must continue during the very difficult school-to-work transition period, and then must be reinforced through effective skills training upon entrance into the labor market. This can only be accomplished through joint private and governmental efforts.

Second, equal employment opportunities for minorities are a fundamental prerequisite of a full employment economy. Minority citizens suffer disproportionate rates of unemployment for several reasons, but studies have shown the primary contributing factors are inadequate skills and educational training, the continuing existence of discriminatory hiring practices, and the resulting alienation of the individuals affected by such a lack of job opportunity.

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[1] This indicator is discussed in "Total Weeks of Unemployment: A New Measure of Labor Market Distress," a staff study prepared for the Joint Economic Committee, June 30, 1983.

Third, more than half of all women are now active participants in the labor force and studies show that women work for the same reasons as do men—to provide for the livelihood of their families and themselves. While more and more women are enjoying the rewards of employment, a disproportionate number have also been forced into joblessness by the Reagan recession, and continue to be the objects of discriminatory hiring and pay practices.

Fourth, the American economy is changing, and the resulting upheavals in former bulwarks of American industry, such as auto and steel, have resulted in severe labor market problems for the workers in these and other heavy industries. The BLS has projected that the greatest increase in jobs for the future will come from industries such as medical care, business services, professional services, and computer and instruments manfacturing. Technological change is apt to remove some job classifications altogether, while creating training and skills requirements for many new positions.

Over the next decade, labor market growth is projected to slow and its composition will change. In the late 1970's, 2.5 to 3 million people a year were entering the labor force; by the early 1990's, the number of new entrants is projected to drop to about 1.3 million. Women, blacks, and other minorities and people of prime working age are expected to account for a larger share of the total labor force than they do today, and young people will decline in actual numbers.

The following specific, targeted structural labor market policies are needed:

First, we need quality education. Our schools are not adequately preparing all of our children equally or effectively for the challenges of our changing economy. In order to succeed in the labor market, an individual must take with him or her some basic knowledge and skills. Literacy efforts must be increased; computer technology must be an integral part of every education. Local businesses must become involved in assisting schools, so that they can receive an adequately prepared work force. Specifically, businesses should provide schools with more occupational information, access to successful business role models, and financial assistance for better school-to-work instructional materials. The Federal Government must expand its efforts at assuring quality education for all, including special assistance to economically and socially disadvantaged youngsters.

Second, we must combine work experience with basic skills and training. As an effective answer to the problems of youth unemployment especially, we support programs which match employer-sponsored on-the-job training with governmental subsidized basic education and skills assistance.

Third, we need improved labor exchange functions. We must improve the efficiency of labor exchange systems (employment services), and in particular aid in computerization of matching people with available jobs. This information should be shared with guidance counselors at schools, as well, so the loop is closed between school-to-work transition.

Fourth, we need more retraining efforts. Displaced workers need targeted assistance from business, labor, and the government in order to gain the new skills necessary to compete in the changing economy.

Fifth, there is a role for targeted fiscal assistance. It is wholly appropriate that the government step in to help high unemployment communities and individuals to create employment opportunities where public goals are served and private employment opportunities do not suffice. Scarce Federal dollars must be targeted to areas where needs exist, as in public infrastructure, and to community services where inadequate services are available for those in need (i.e., public safety, health care, child care).

Sixth, we need tough anti-discrimination efforts. Business, labor, and government must eradicate discriminatory hiring practices in order for full employment to be a reality. We endorse strict enforcement of equal employment opportunity laws and regulations.

Some positive steps have already been taken.

During the worst of the recession, Congress took the initiative and approved a $3.5 billion emergency job appropriations bill to provide assistance to and generate jobs for the unemployed. The bill included $1 billion for the Community Development Block Grant (CDBG) program, and $255 million for employment and training for displaced youth and older workers.

The Administration proposed $4.3 billion in budget authority to fund the Job Training Partnership Act (JTPA) for 15 months, including funds for summer youth employment, dislocated workers, and basic training grants. The Congress provided $6.4 billion in the Labor-Health and Human Services (HHS) Appropriations Act to fund JTPA for 21 months.

The JTPA authorizes grants to states and local areas for such services as job counseling, classroom training and education, and on-the-job training for low-income youth and adults. We believe that JTPA is necessary if employment of the hard-to-employ workers is to be achieved.

Further steps are needed.

We support the action of Congress to provide $170 million in budget authority in the Labor-HHS Appropriations bill to continue the Work Incentive (WIN) program from which approximately 200,000 welfare recipients will enter employment. The Administration had proposed to eliminate funding for the WIN program. In addition, we support the decision by Congress to provide $317 million in budget authority in the Labor-HHS Appropriations bill for the older American's work program which will provide 62,500 part-time jobs for the elderly. This program would have been reduced substantially had certain provisions been consolidated into a block grant.

In 1983, the Administration did not propose any significant employment programs. The House nevertheless passed several pieces of an employment and recovery program to provide temporary jobs to the long-term unemployed. It is estimated that 500,000 unemployed persons would have benefited from this program. This program was designed to provide both immediate assistance (community renewal jobs, health insurance for the unemployed, foreclosure relief) and long-term recovery (research and development, education assistance, math-science initiatives). We continue to support measures to meet the needs of the long-term unemployed and others hurt by the recession, and to promote competitiveness as the expansion proceeds.

TABLE V-2.—JOBS AND ECONOMIC RECOVERY PROGRAMS

[In billions of dollars]

House passed programs	Proposed fiscal year 1985 outlays
Health insurance for the unemployed (H.R. 3021)	1.60
Foreclosure relief:	
Farmers (H.R. 1190)	.60
Homeowners (H.R. 1983)	.35
American Conservation Corps (H.R. 999)	.25
Community renewal employment (H.R. 1036)	3.50

2. COMPETITIVENESS

For the long term, America needs a new vision of an internally cooperative, internationally competitive future. Our labor force and our private business managements must be prepared to compete—and win—against a more sophisticated array of foreign producers than ever before. To assure success, government must play a constructive, but not intrusive role. We need a program of public investment in people and communities that will enhance our prospects for sustained growth, promote fairness in our society, and rebuild a cooperative foundation for long-term prosperity.

Both the House and Senate Democratic Caucuses have presented comprehensive strategies for American renewal in the 1980's and 1990's. In September 1982, the House Democratic Caucus,[2] under the leadership of Caucus Chairman Gillis W. Long, adopted "Rebuilding the Road to Opportunity: A Democratic Direction for the 1980's." In November 1983, the Senate Democratic Caucus,[3] acting under the Senate Democratic Leader Robert C. Byrd and Task Force Chairman Edward M. Kennedy, adopted "Jobs For The Future: A Democratic Agenda." Finally, in January 1984, the National-House Democratic Caucus,[4] cochaired by Congressman Gillis W. Long and Mr. Robert S. Strauss, presented "Renewing America's Promise: A Democratic Blueprint For Our Nation's Future."

These proposals contain elements similar to those of a broad-based competitiveness strategy which this Committee has developed in extensive hearings,[5] studies,[6] and in our past annual reports. They reflect a new, widely shared consensus among Democrats on the path that long-term economic policy must take. It is worth reviewing the basic points of that consensus.

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[2] The House Democratic Caucus consists of the entire Democratic Membership of the House of Representatives.

[3] The Senate Democratic Caucus consists of the entire Democratic Membership of the Senate.

[4] The National-House Democratic Caucus is a 153-member group consisting of 70 House Democrats, top officials of former Democratic Administrations, and many leading Party members from the worlds of business, labor, scholarship, and civic action.

A first point of agreement is in opposition to the Reagan Administration's macroeconomic policy. The 1982 House Caucus document says flatly: "Reaganomics must—and will—be repealed." Congressional Democrats enjoy unanimity on the need for lower deficits and lower interest rates. It is also agreed that Federal involvement in industry does not substitute for rapid, sustained, balanced economic growth, which such a shift in the policy mix would be designed to bring. All of these documents share the premise, set forth explicitly in the 1982 Joint Economic Report, that the purpose of industrial policy is to facilitate the transitions which growth makes inevitable. Such policies are a poor use of resources in a general climate of stagnation.

Second, there is agreement in principle on the main elements of an adjustment strategy apart from industrial policy proper. There should be investment in *people*, through expanded support for public education and for job training. There should be investment in *knowledge*, through expanded support for basic science, for university and government-sponsored research, and through modified antitrust and tax treatment of commercial research and development. There should be investment in *infrastructure*, including road, rail, and water transport, water and sewer treatment, ports, bridges, tunnels, and city streets, all of which have slid into disrepair. There is full understanding of the link between infrastructure maintenance and the preservation of older industrial communities as sites for new industrial investment, and between infrastructure investment and growth in expanding regions.

Third, trade *protection* plays no part in our strategy. Adjustment, not protection, is needed, and we seek to build the political coalitions that would make an adjustment strategy feasible. The Senate Democratic Caucus tackles this issue head-on:

> While we insist on a full and firm application of the laws designed to protect American firms and workers from unfair and predatory competition, "we reject permanent protectionism as a solution to our problems." It is difficult to have economic growth without a substantial export sector, and it is impossible to envision that we will be able to export successfully without continuing to be a sizeable market for other countries' goods. Given the international debt situation, and continued recession in much of the

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[5] "Business Management Practices and the Productivity of the American Economy" (May 1, 11, June 1, 5, 1981), "Japanese and American Economic Policies and U.S. Productivity" (June 23, July 28, 1981), "Industrial Policy" (May 18, 1982), "Japanese Industrial and Labor Policy" (June 23, 1982), "Industrial Policy, Economic Growth and the Competitiveness of U.S. Industry, Part 1" (June 24, 29, 30, 1983), "Industrial Policy, Economic Growth and the Competitiveness of U.S. Industry, Part 2" (July 13, 14, 20, 1983).

[6] "Monetary Policy, Selective Credit Policy, and Industrial Policy in France, Britain, West Germany, and Sweden" (June 26, 1981), "International Competition in Advanced Industrial Sectors: Trade and Development in the Semiconductor Industry" (February 18, 1982), "The Japanese Financial System in Comparative Perspective" (March 12, 1982), "The Mercantilist Challenge to the Liberal International Trade Order" (December 19, 1982), "U.S. International Economic Policy in the 1980's" (February 11, 1982), "Policies for Industrial Growth In a Competitive World" (forthcoming, March 1984).

> world, we have no choice but to encourage developing countries to export . . .

With respect to specific parts of the strategy, House and Senate Democrats agree on the major principles which must apply.

A first principle is the *principle of cooperation*. Democratic industrial policy would be a consultative process, primarily between business, labor, and government, but with additional input from environmental, consumer, and other organized constituencies. Our emphasis on consensual processes takes on special significance in the present context, which is the most adversarial and specifically anti-labor of modern times. By stressing tripartite cooperation, we signal to labor that their place in a balanced consultative process, alongside business and government, will be respected.

A second principle is the *principle of balance*. We reject the artificial distinctions between "winning" and "losing" industries, between "smokestack" and "hi-tech," and between "sunrise" and "sunset." The world admits to few such clear-cut distinctions. High technology is as important to the revitalization of declining industries as to the creation of new ones (witness robots in automobile manufacture), and some of the more prolific job-creating growth sectors of our times have not been particularly high technology at all.

A third shared principle is that of *experimentation*. The 1982 Joint Economic Committee Report coined the concept of involvement in *catalyst* industries—those with strong linkages backward and forward in the economy, or which met particular national needs. For example, the Committee found that full development of U.S. potential for coal production and export is hampered by inadequate transport and port infrastructure, and by the need for large-scale environmental investments. A public industrial policy might usefully coordinate a national program to help overcome these obstacles and meet the potential. A similar case can be made for development of high-speed, interurban corridor passenger rail systems, on the ground that such systems form a part of a balanced and efficient transportation infrastructure.

The Senate Democrats push the principles of balance and experimentation even further, by recommending that aid to industry be channeled through the economic development agencies of the states. This would tend to favor relatively small projects and would minimize the risk of giant technological gambles going sour. Also, it would help make initiatives diverse.

Finally, there is a *principle of openness*. We are deeply skeptical of schemes to delegate authority for large bail-outs to an agency of the Executive Branch. The present system is too often criticized for its virtues: it is open, it is *ad hoc,* it is political. Under the present system, any company seeking Federal assistance on a large scale must come before the Banking Committees of the two Houses and submit to exhaustive questioning from Members of all persuasions, interests, and constituent perspectives. This is the best assurance against moral hazard—the danger of supplication from the not-truly needy. In the recent cases of Chrysler and New York City, it has been Congress—not the Executive Branch—which has imposed requirements for sacrifice from all beneficiaries of major Federal assistance as a condition for aid. And Congress has reason to be proud of its judgment in a number of specific decisions. It cut off funding for the Supersonic Transport in 1971 after several years of support. It did not bail out the Penn Central Railroad. It did, eventually, kill the Clinch River Breeder Reactor. The safeguards of openness and broad political participation must be preserved in any institutional changes which may be made.

Together these documents outline a strategy for preparing our Nation to adapt to the sweeping economic changes affecting the international marketplace. This strategy recognizes that America's economic isolation has ended and we now are facing sophisticated new competitors in the fast-changing international economy. Compounding this challenge, our businesses and workers must adjust to unprecedented changes in technology, production processes, and markets. Our economic prosperity and our standard of living will henceforth depend on whether we organize successfully to meet foreign competition.

In the face of this challenge, both the House and Senate Democrats recognize the need to foster a spirit of cooperation in our society, to reduce antagonisms among business, labor, and government, and to establish a forum where all these parties can meet to seek a consensus on pressing problems. To translate such a renewed spirit of cooperation into practice, House and Senate Democrats propose creating a broadly representative, independent council to debate and formulate the Nation's strategy for economic growth. Subcouncils would be established to analyze and consider specific industries and regional problems. The council would be responsible for collecting, analyzing, and reporting on changing economic trends.

Second, there is general agreement on the usefulness of a new "Technology Foundation" or a series of "Centers for Industrial Technology," modeled along the lines of the National Science Foundation, whose purpose would be to fund research and development of potentially commercial technologies in conjunction with university schools of engineering and private laboratories. Such an agency would provide a civilian counterpart to the Defense Advanced Research Projects Administration (DARPA) and would adapt its priorities to the needs of the peacetime economy. At the same time, standards of peer review would provide safeguards against funding of wasteful or unpromising projects.

House and Senate Democrats know that, to grow tomorrow, we—both the private and public sectors—must make investments today in research and development, in education, in training and retraining, and in trade promotion. By adopting farsighted investment policies, our economy and our workers can better adjust to rapid changes, can become more productive, can generate new and higher quality jobs, and can meet foreign competition.

The strategy of the House and Senate Democrats will be effective if we are able to keep our economy on the path of economic growth. Both in creating this healthy economic climate and in focusing on the special needs of various sectors of our economy, this strategy recognizes that the government cannot be a passive bystander taking no action as the winds of change sweep across our land.

ADDITIONAL VIEWS

ADDITIONAL VIEWS OF SENATOR LLOYD BENTSEN

INTRODUCTION

Vice Chairman Hamilton, the Democratic Members, and staff are to be complimented for the effort involved in preparing the views and proposals presented in this Report. They represent a thought-provoking approach to addressing the most pressing economic issue facing our Nation: sustaining a robust noninflationary recovery while reducing the yawning budget deficit to manageable size. The Report will enrich the current debate on economic policy, and I offer these additional comments to more clearly state my individual views.

THE ADMINISTRATION BUDGET AND SAVINGS, INVESTMENT, AND PRODUCTIVITY

The Administration did not propose effective steps in its Fiscal Year 1985 budget to reduce the ballooning Federal deficit. It offered largely cosmetic proposals to reduce the deficit, including a series of long-run administrative steps of dubious constitutionality. The Administration pointedly rejected cost savings of $100 billion or more which the Grace Commission maintained could be achieved solely by the White House without congressional approval. Even its proposed scant 15 percent downpayment reduction in the deficit was greeted by Main Street and Wall Street with a wave of stock selling which sent the Dow-Jones Industrial Average down 13 percent in a month. Moreover, in a sharp departure from previous presidential budgets, the White House included unsubstantiated economic projections in its budget which were neither internally consistent nor based on Administration budget proposals. These projections sketched a misleading and far rosier economic future for this Nation than current Administration policy is capable of generating.

The Administration's budget indicates that fiscal responsibility and closing the deficit gap is not a White House priority. Its do-nothing budget seeks near-term temporary gain at the risk of a longer term weakening of this Nation's economic foundation. In the nearer term, inaction in the face of large deficits will generate inflationary pressures which will reinforce the already present inflation potential as our economy approaches full capacity. In addition, as the recovery matures, the Federal deficit will crowd out financial markets and push up interest rates as private borrowers and the Treasury compete for scarce savings. In fact, just Treasury interest payments on the debt generated by White House inaction on the deficit in 1984 and 1985 alone will add nearly $40 billion annually to the deficit. And the total interest garnish on future budgets from the fiscal 1982–1985 Reagan Administration deficits will exceed $75 billion annually—or $300 each year for every man, woman, and child.

The higher future interest rates promised by the Administration's economic program will exacerbate our Nation's precarious productivity performance. The President came to office pledging to restore our Nation's sagging investment, savings, and productivity. He did not. Indeed, personal savings rates have declined consistently under the Administration despite record real interest rate levels. Last year, an extraordinary 40 percent of our net domestic investment was financed with savings borrowed from overseas. It will be higher this year as the Administration's deficits continue to force this Nation along the path to becoming an international debtor of Homeric proportions.

The recovery, sparked by the Federal Reserve's expansionary course in 1982 and 1983, has generated a thankful boost in equipment investment and productivity. These gains have been limited, however. Productivity grew only 3.5 percent in 1983, well below the average 4.9 percent rate marked up during the first year of all other postwar economic recoveries. Yet, even those relatively poor gains are imperiled by the high level of real interest rates. Despite the recovery, productivity growth saged to 1 percent in the fourth quarter of 1983. And the President's Economic Report this year considerably retreated from its earlier rosy productivity growth projections. It predicted a productivity growth rate of 1 percent or less by 1988, well down from the handsome 2.6 percent projected in the January 1982 Report. Even this week productivity projection may be unobtainable in the face of continued high interest rates. The President's 1981 economic program did not aid productivity. His 1984 economic program may ensure that it remains at low levels into the foreseeable future.

Fiscal and Monetary Policy

The deficit gap cannot be closed immediately without risking another deep recession. Yet, greater spending cuts and larger taxes are needed promptly to begin closing that gap and prevent rising interest rates. In addition, this Report and the Administration note the need for tax simplification and greater fairness. I join in that call. As a quick first step in that direction, a much more aggressive effort must be made to corral tax evaders and collect overdue taxes. The Grace Commission put the amount of uncollected taxes at some $100 billion alone, and estimated that billions more go unreported.

Economic leadership by White House default now rests with Congress and the Federal Reserve System. This places the nominally independent Federal Reserve System in an awkward position. After ending the Reagan experiment in mid-1982 and generating the present recovery, the Federal Reserve returned last year to a more moderate anti-inflation posture. M1, for example, grew at an annual rate of about 6 percent in the last two quarters of 1983. This more moderate monetary policy has raised White House fears that crowding out may push interest rates up as early as this year. In light of the growing inflationary risks, a more expansionary monetary policy should be resisted until effective tax and spending actions have occured to shrink the deficit gap. That less-expansionary fiscal policy would create room for the Federal Reserve to accept slighly greater monetary expansion without realizing fears of renewed inflation and the higher long-term interest rates it brings. That policy prescription has the highest probability, as well, of sustaining a robust recovery well into the future unhindered by rising interest rates. Finally, it offers the best outlook for continued growth in both investment and productivity, which should be this Nation's longer run economic goals. The Federal Reserve should avoid a return to runaway growth, or stop-go policies with monetary aggregate growth tied to interest rate targets.

TRADE POLICY

Our enormous deficits threaten higher interest rates and a steady erosion of our Nation's competitiveness, productivity, and prospects for economic growth. They have a direct and dramatic impact on trade, as well. The free world is further away from free trade today than at any time since World War II. And the Administration has been strikingly unsuccessful in reversing this tide. In fact, the Administration's unwillingness to seriously grapple with our soaring deficits has brought us to the brink of a worldwide trade war. This threat has been compounded by drift in the Administration's trade policy and failure to deal with the unfair foreign trade subsidies bedeviling our foreign trade sector.

By keeping real interest rates above yields abroad, the flood of foreign capital lured by the Administration's deficits pushed the dollar to record levels. It has risen 44.5 percent on a trade-weighted basis in real terms since 1980, crippling both U.S. exports and the sales of U.S. firms who are competing at home with underpriced foreign goods. According to the President's Council of Economic Advisors, fully one-half of the projected 1984 $110 billion trade deficit is attributed to the deficit-bloated dollar. The debilitating impact on agriculture and basic industries like steel has been particularly dramatic.

Damaged by deficits originating in Washington, many foreign trade sector industries are seeking help from Washington. They have seized on the burgeoning use by foreign governments of unfair trade subsidies as one vehicle. Such subsidies range from cheap government credit and controlled input prices to outright cash grants of the type made, for example, to European agriculture exporters. These practices have increased sharply in recent years as the Reagan recession spread abroad and foreign firms fought to maintain sales by expanding exports with government help.

These patently unfair trade practices are not adequately defined in the General Agreement on Tariffs and Trade (GATT) or its Subsidies Code. The Administration has made no progress within GATT in rectifying these ambiguities, much less limiting their use. It has been no more successful in limiting the use of unfair trade practices in a variety of bilateral negotiations either, in particular with Japan.

Our foreign trade sector, labor and management alike, has watched the growth of foreign subsidies with alarm. The Administration cautioned patience, urging restraint in order for it to negotiate an end to such subsidies. That admonition would have been better received had the deficit-driven dollar not so weakened the foreign trade sector. But the unfair burden imposed on that sector by the deficits precipitated a rash of unfair trade cases beginning in 1982. With no progress to show in clarifying the illegal status of subsidies under GATT, the Administration has reacted in an *ad hoc* and confusing fashion to these domestic requests for compensatory trade restrictions. For example, the Administration found that a number of foreign specialty steel firms enjoyed unfair government subsidies. It imposed a variety of quotas and duties last year to offset the impact on U.S. steel firms of these subsidies. The ensuing controversy, within both GATT and NATO, is a poignant commentary on the Administration's failure to deal with unfair foreign trade practices. Under terms of GATT, such offsetting trade controls could be imposed when unfair trade practices exist abroad without the United States offering compensation to foreigners for sales consequently lost in the U.S. market. But as one, our European allies demanded such compensation, asserting that their subsidies were not illegal under terms of GATT. Indeed, they just recently retaliated with quotas and duties of their own on U.S. chemicals and athletic equipment.

These opening rounds of an old-fashioned trade war may not spread. But they should nonetheless be viewed by the Administration as the strongest possible indication of an international trading system hovering on the brink of Eighteenth-Century mercantilism. Prompt and immediate repair of the arcane and antiquated GATT rules covering unfair trade practices in needed. Major segments of our economy are endangered by such practices. These industries and their employees have far more to gain from a leveled international trade playing field than from a trade war. Moreover, the Congress should not be forced to exercise leadership for the White House on this trade issue. Yet, that may occur should the Administration continue to focus on the symptoms of a world trading order in disarray rather than on moving that order toward free trade once again.

ADDITIONAL VIEWS OF SENATOR WILLIAM PROXMIRE

I commend Vice Chairman Hamilton and the Committee staff for the Democratic Views on the Economic Report of the President. I agree with much of the Democratic views and especially with the sense of urgency conveyed regarding the need to reduce the deficit. The problem of reducing the deficit is not only urgent, it is an extraordinarily difficult economic problem.

In my view, the present policy of the Federal Reserve Board is about right. If the Congress should reduce the deficit well below the roughly $200 billion per year level—interest rates would fall, with the fall in inflationary expectations. An increase in the money supply any time soon might have inflationary consequences and would increase inflationary expectations, thus raising interest rates.

I would not recommend that the Federal Reserve increase the rate of growth in the money supply to advance the economy's growth rate from the 4.5 percent level estimated by the Administration for 1984 because of the possible immediate and longer term inflationary consequences due to the demonstrated lag effect of Federal Reserve policy. Documentation submitted to the Senate Banking Committee by the Treasury Department shows a six-month to nine-month lag between the determination of monetary policy by the FOMC and the effect of that determination of monetary policy by the FOMC and the effect of that determination on growth and employment. This means that, if the Federal Reserve should in its March meeting decide to change its targets and expand the money supply more sharply, it would not begin to affect the economy until the end of 1984 and the beginning of the third year of the recovery (the recovery started in November of 1982). The result could be an increase in the growth rate of GNP in the third year of the recovery when the circumstances will make it much more likely that inflation will again get out of control in view of the probable high levels of employment, production, and capacity uitilization at that time, and the possible fall in the value of the dollar.

In view of the fiscal debacle that has given our government the most inflationary peacetime deficits in the Nation's history, we should not force the Federal Reserve into an inflationary monetary policy to match the Administration's and Congress' inflationary fiscal policy. The Committee joins the overwhelming popular demand that the Congress promptly and sharply reduce the deficit. Unfortunately, wishing will not make it so. That will take congressional persistence. It will take political courage. And, especially, it will take luck to avoid a recession for the next four or five years. The odds for achieving all this are not great. I would not recommend an easier monetary policy to start at once on the grounds that a more prudent fiscal policy may go into full effect several years from now. To do first things first, we must concentrate on correcting the current outrageous fiscal policy. The Democratic views correctly urge enactment of the deficit-reduction package before there is a change in monetary policy. We should await the actual implementation of the wiser fiscal policy—unlikely as that implementation might be—before modifying a monetary policy that single-handedly and in the face of an inflationary fiscal policy gave this country far and away the sharpest improvement in inflation in the Nation's history.

ADDITIONAL VIEWS OF REPRESENTATIVE AUGUSTUS F. HAWKINS

I want to express my appreciation to Vice Chairman Hamilton and the staff for the many hours of competent and professional effort that went into formulating the economic policies and programs the Democratic Members of the Joint Economic Committee offer as an alternative to President Reagan's misguided economic agenda. I am supportive of most of the programmatic suggestions and am pleased to join with my colleagues in signing this Report.

However, in my view, it is not appropriate to place an overriding emphasis on reducing the deficit as the primary means for achieving the goals of full employment and price stability.

DEFICITS

The enormous budget deficits currently facing us are a product of the worst recession since the Great Depression, the inequitable tax cuts enacted in 1981, and the huge inappropriate increase in military spending. Added to this is the unnecessarily restrictive policy of the Federal Reserve Board, which is keeping interest rates higher than needed, and the interest payments we have to pay on the public debt higher, as well. Contrary to what the President and others are saying, domestic spending has not contributed to our current imbalance. In actuality, spending for the so-called safety net programs has most likely saved us from an economic scenario of depression proportions. If anything, we need to target increased domestic spending in areas of human and economic need, while taking a different macroeconomic approach.

I believe a more appropriate response to the current underutilization of our people and our resources is a comprehensive program based on full employment and full resource use, along with a strong and targeted anti-inflation program that will safely enable us to pursue the Full Employment and Balance Growth Act's medium-term goals of 4 percent unemployment and 3 percent inflation.

The unacceptable $200 billion deficits of today would be immediately reduced if we followed such an alternative because currently unused plant and idle workers would become productive in those areas of our economy where needs exist and goods or services are scarce. We would have an immediate increase in revenues from taxpaying individuals; immediate decrease in government transfer payments; and potential inflationary pressures would be contained due to the targeted anti-inflation program that would be part and parcel of a coordinated policy.

Deficit reduction should be the end result of a coordinated and comprehensive economic policy based on vigorous and balanced growth; not an answer in and of itself.

GOALS

I am pleased to see a section on economic goals included in our Democratic alternative. We have acknowledged the importance of setting economic goals to help us to achieve our economic objectives. Unlike the Administration, which refuses to set goals despite statutory mandates, Democrats know that it is important to measure and evaluate the progress we make; accountability must be a fundamental aspect of our economic policy decisionmaking, and our Report takes a step in the right direction by discussing how the alternative policies we offer can bring us into closer compliance with the statutorily mandated goals of the Full Employment and Balanced Growth Act.

As can be noted in testimony received during the JEC's annual report hearings, there continues to be substantial economic support for the feasibility of achieving 4 percent unemployment consistent with low inflation or actual price stability.

ENTITLEMENTS

Finally, I do not believe that entitlement programs are "fair game" in our efforts to reduce the budget deficits. While waste and mismanagement should always be properly addressed, we should not lose sight of the facts. Current entitlement programs fall short of providing basic assistance to many people who rightly deserve and are entitled to support. Entitlement programs are not the root cause of the budget imbalance. Deficit reduction actions should be based on directly attacking the real causes of the deficit, as explained above, and by following a policy of strong and balanced growth. Only after the real causes have been addressed, do I feel it is appropriate to study ways to adjust entitlement expenditures.

CURRENT SERVICES BUDGET ESTIMATES

CURRENT SERVICES BUDGET ESTIMATES[1]

The Congressional Budget Act of 1974, as amended, requires that the President submit a current services budget to Congress. This budget presents the level of outlays and budget authority "for the following fiscal year if programs and activities of the United States Government were carried on during that year at the same level as the current fiscal year without a change in policy." Such benchmark estimates and the corresponding current services receipts estimates are to be accompanied by "the economic and program assumptions on which those budget outlays and budget authority are based, including inflation, real economic growth, and unemployment rates, program caseloads, and pay increases." The current services budget plays a vital role in expediting efforts of congressional committees and the Administration to develop and evaluate timely and credible policy alternatives. Current services outlays by function and receipts by source for 1985 are compared with the corresponding proposed 1985 amounts in Table I. The deficit, off-budget outlays, and total budget authority are also shown.

TABLE I.—RECEIPTS BY SOURCE AND OUTLAYS BY FUNCTION, ADMINISTRATION'S CURRENT SERVICES BUDGET AND PROPOSALS FOR FISCAL YEAR 1985

[In billions of dollars]

	Current services budget	Administration proposal	Difference from current services
Receipts:			
Individual income taxes	$323.4	$328.4	+5.0
Corporation income taxes	75.5	76.5	+1.0
Social insurance taxes and contributions	269.0	270.7	+1.7
Excise taxes	38.4	38.4	.0
Other	31.0	31.0	.0
Total receipts	737.3	745.1	+7.8
Outlays:			
National defense	284.2	272.0	−12.2
International affairs	14.1	17.5	3.4
General science, space, and technology	8.4	8.8	.4
Energy	3.4	3.1	−.2
Natural resources and environment	11.8	11.3	−.5
Agriculture	14.3	14.3	(1)
Commerce and housing credit	1.6	1.1	−.4
Transportation	27.4	27.1	−.4
Community and regional development	7.7	7.6	−.1
Education, training, employment, and social services	29.0	27.9	−1.1
Health	34.4	32.9	−1.5
Social security and medicare	261.4	260.3	−1.1
Income security	116.9	114.4	−2.5
Veterans benefits and services	26.6	26.7	.1

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[1] All years referred to are fiscal years.

TABLE I.—RECEIPTS BY SOURCE AND OUTLAYS BY FUNCTION, ADMINISTRATION'S CURRENT SERVICES BUDGET AND PROPOSALS FOR FISCAL YEAR 1985—Continued

[In billions of dollars]

	Current services budget	Administration proposal	Difference from current services
Administration of justice	6.2	6.1	(1)
General government	5.7	5.7	(1)
General purpose fiscal assistance	6.8	6.7	−.1
Net interest	117.9	116.1	1.8
Allowances	1.5	0.9	−.5
Undistributed offsetting receipts	−34.6	−35.3	−.7
Total outlays	944.9	925.5	−19.4
Deficit (−)	−207.6	−180.4	27.2
Off-budget outlays	18.0	14.8	−3.2
Deficit (−), including off-budget outlays	−225.6	−195.2	30.4
Budget authority	1,030.8	1,006.5	−24.3

[1] $50 million or less.

Sources: OMB, "Budget of the United States Government, Fiscal Year 1985," pp. 9–4, 9–5; and "Special Analysis A (Current Services Estimates)," pp. A–5, A–6, A–7, A–13.

In previous years, this Committee has called for more detailed current services estimates for a five-year period, to facilitate longer run policy formulation. A major improvement was made in the current services budget last year in that five-year budget estimates were made of total budget authority, receipts, outlays, deficits, and off-budget outlays. Also, differences between current services and proposed outlays by function were presented. This same information was presented in the 1985 budget. The functional estimates would be somewhat more useful if the level of current services outlays by function were shown as well as the differences between current services outlays and the Administration's proposals. In this year's budget, current services outlays by function must be calculated by adding these differences to the proposed outlays.

Current services estimates of budget authority, outlays, receipts, and the deficit would differ if based on an alternative economic forecast. Differences in the outlook for inflation, economic growth, unemployment, and interest rates would in some cases lead to major differences in the current services budget. An indication of the magnitude of these differences is presented in the comparison in Table II of the Administration's current services budget with the similar (though not identical) concepts embodied in the baseline budget projections prepared by CBO.[2] As indicated, by 1989, the Administration foresees a current services deficit of $193 billion, while CBO predicts a baseline deficit of $308 billion. The major source of this difference is the discrepancy between the Administration and CBO forecasts of interest rates over the next five years.

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[2] The CBO baseline figures are from, *An Analysis of the President's Budgetary Proposals for Fiscal Year 1985*, CBO (February 1984), p. 2; these are preliminary revisions of these estimates appearing in, *Baseline Budget Projections for Fiscal Years 1985–1989*, CBO (February 1984).

TABLE II.—RECEIPTS, OUTLAYS, AND THE BUDGET DEFICIT: ADMINISTRATION'S CURRENT SERVICES ESTIMATES AND CBO BASELINE BUDGET PROJECTIONS, FISCAL YEARS 1985–1989

[In billions of dollars]

	1985	1986	1987	1988	1989
Administration:					
Receipts	737	803	874	960	1,037
Outlays	945	1,019	1,094	1,163	1,230
Deficit	208	216	220	203	193
CBO:					
Receipts	733	795	863	945	1,016
Outlays	930	1,012	1,109	1,217	1,323
Deficit	197	217	245	272	308

Sources: OMB, "Special Analyses, Budget of the United States Government, Fiscal Year 1985," February 1, 1984, p. A–5; CBO, "An Analysis of the President's Budgetary Proposals for Fiscal Year 1985," February 1984, p. 2.

The major shortcoming of the 1985 current services budget is its treatment of budget authority and outlays for defense. In a major exception to normal practice, the Administration indicates that the estimated military budget authority for 1985 and outlays for 1985–1989 are not intended to represent costs "if all programs and activities . . . were carried on . . . at the same level as the current fiscal year without a change in policy," the definition of current services in the Budget Act, as amended. Rather, the 1985–1988 estimates are from the Administration's 1984 Midsession Review budget request. This baseline for defense contradicts the Administration's own definition of the current services budget as providing estimates that "reflect the anticipated costs of continuing ongoing Federal programs and activities at present levels without policy changes (that is, ignoring all new initiatives, presidential or congressional, that are not yet law)." The basis for current services defense estimates has major implications, as discussed in detail in our report last year.

In summary, the current services budget has been improved in the last two years by providing more detailed estimates of outlays by function and receipts by source over a five-year period. A five-year analysis of current services budget authority by function would also be useful. In the defense area, the Administration has again departed from the basic definitions of current services in the Budget Act, as amended. In the future, the analysis of the defense program should be based on a legitimate current services concept, not on the previous year's budget proposals.

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